HOLMES
INCOME
TAX

FEDERAL INCOME TAX

INCLUDING TAX ON UNDISTRIBUTED NET INCOME, CAPITAL STOCK TAX, AND WAR EXCESS PROFITS TAX

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PREFACE

It is fortunate that we passed an Income Tax law in 1913. It would be better for us now if we had done so ten years earlier. Without an Income Tax we could not raise the tremendous sums of revenue now required; and with a new law, the Internal Revenue employees would be like an army of raw recruits. They have had a period of training under the 1913 and 1916 Income Tax Laws which is now of inestimable value.

Our system of Income Tax Laws is still defective. Years of slow development are needed to make it work smoothly and effectively. This can take place only by the discovery and application of correct principles to the multitude of single cases which will arise for settlement either by the Treasury Department or by the Courts. This book attempts to show what the law is in its present state of development and to present the matter in a form readily accessible to the reader. It is not a discussion of the principles of taxation but a practical handbook for present use, and it is the author's hope that it may be found of some value for that purpose. Criticisms of its shortcomings and suggestions for its improvement will be thankfully received.

Much criticism has been directed against the Treasury Department for its narrow construction of many provisions of the law. No doubt its rulings work hardship on occasion, but no other course can be adopted. The

Treasury Department is not a judicial body—the purpose of its existence is to collect revenue. The first rulings and the general rulings must construe the law narrowly, leaving the taxpayer to protest if they operate unfairly in his case. If a broad construction were indulged in generally, no taxpayer would ever call attention to the cases where it resulted in allowing revenue to escape. The door must first be tightly closed and then opened in particular instances where necessary and proper. It is the right and the duty of every taxpayer to protest when he feels the administration of the law operates unfairly as to him. The law makes special provision for him to do so.

Unfortunately there are citizens who do not scruple to evade taxes by every means at their disposal. The rulings must be made with that fact in view, that is, they must be such as will make it difficult for the "tax-dodger" to hide behind any statement of the officers charged with the administration of the law. The conscientious taxpayer is sometimes penalized because of this, but unless he sleeps on his rights, he has his remedy at hand.

The personnel of the Treasury Department is actuated by a high sense of public duty. The author has had the pleasure of association with many officials, collectors and inspectors in the past and has found them intelligent, fair-minded and just in their dealings with the taxpayer. Differences of opinion as to taxable income or allowable deductions must necessarily arise, and when they do, the officials of the Treasury Department stand always ready to give the taxpayer full opportunity to express his view and to raise his argument. If they do not agree with him, it is because they are bound by what they understand the law to mean, even though they recognize the

justice of his contentions. The ultimate remedy in many cases is to improve the statute, a matter to which the average taxpayer pays no attention.

It is the hope of the author that this book may point out some of the needs for amendment of the statute as well as to give the taxpayer a clearer idea of the system by which the taxes are assessed, collected, abated and refunded. The author's thanks are extended to the many friends who have given him helpful suggestions and criticisms in preparing the work, and particularly to Mr. A. E. Young of the Pittsburgh Bar and to Messrs. Ross W. Lynn and T. A. Clements of the New York Bar for their careful reading of the manuscript.

GEORGE E. HOLMES.

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FEDERAL INCOME TAX

CHAPTER I

INTRODUCTION [1]

At present the Federal Income Tax is imposed under two statutes prescribing separate and different rates, one additional to the other. The Act of Sept. 8, 1916 (referred to in this book as the 1916 Law) imposes a tax at comparatively low rates and with comparatively high exemptions. This Act was amended in many respects by the Act of October 3, 1917, but remains as a separate law imposing a general income tax in contradistinction to the "war income tax" which was also included in the Act of October 3, 1917 (and which is referred to in this book as the 1917 Law.) The 1917 Law contains no administrative provisions, but it provides that the tax it imposes shall be computed, levied, assessed, collected and paid upon the same basis and in the same manner as the similar taxes imposed by the 1916 Law. Generally speaking both laws are adminis-

[1] The purpose of this chapter is to describe briefly the salient provisions and requirements of the law and the system of administration, so that the reader may obtain a general understanding of the subject before the various provisions are taken up and discussed in detail.

tered as one, and only one return of annual net income is required from each taxpayer, on the basis of which both taxes are assessed.[2]

Preceding Federal Laws. The 1916 Law was preceded by the Act of October 3, 1913, (referred to in this book as the 1913 Law.) This law remained in force without change or amendment up to September 9, 1916, when the 1916 Law went into effect. The 1916 Law contained several important amendments and effected an increase in rates of the normal and supertaxes, but the general provisions of both laws remained very much the same, and rulings and decisions under the 1913 Law are freely referred to in this book as they have direct application to the provisions of the laws now in force. While the 1913 Law was the first general income tax law enacted after the adoption of the Constitutional Amendment permitting the imposition of an income tax without apportionment and without regard to any census or enumeration, there was in effect in this country from August 5, 1909, to January 1, 1913, a corporation excise tax act (referred to in this book as the 1909 Law) which imposed a special excise tax on corporations with respect to the carrying on or doing business by such corporations. Though the 1909 Law was not intended to be and was not in any proper sense an income tax law[3] the tax was

2 The purpose of Congress in enacting a separate ''war income tax'' law instead of increasing the rates of the 1916 Law, was no doubt to facilitate a return to the lower rates when the present extraordinary demand for revenue has ceased. Thus, the present high rates and low exemptions are superimposed temporarily upon our general low rates and high exemptions, a return to which is made all the more easy by leaving the 1916 Law intact.

3 Justice Pitney in Stratton's Independence Limited v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136, 58 L. Ed. 285.

measured by the net income of corporations and the language of the subsequent income tax laws is in many instances either verbatim or very similar. To that extent decisions and rulings under the 1909 Law throw light on the construction of the present laws and for that purpose are referred to in this book.

Administration of the Laws. The duty of administering the income tax laws and collecting the taxes thereunder is imposed on the Bureau of Internal Revenue, which is a part of the Federal Treasury Department. The bureau is in the charge of the Commissioner of Internal Revenue, who, under the direction of the Secretary of the Treasury, has general superintendence of the assessment and collection of all duties and taxes imposed by any law providing internal revenue.[4] The states and territories are divided into some sixty-four collection districts,[5] each under the charge of a collector of internal revenue, with one or more deputy collectors. Returns of net income are filed with the local collector and the tax is paid to him, although the assessments are made by the Commissioner of Internal Revenue at Washington. Collectors have supervisory power over, and authority to investigate, all accounts, lists or returns required to

[4] U. S. Rev. Stats., § 321.

[5] As a rule the boundaries of collection districts coincide with the boundaries of the states, but sometimes one collection district embraces two or three states, or one state is divided into two or more collection districts. Districts within a state are designated by number, as the first and sixth districts of California, being the two districts of that state. The lack of sequence in numbering is due to the consolidation of districts from time to time since the period immediately following the Civil War, when the country was divided into the maximum number of districts.

be made by persons liable to tax,[6] may send agents to examine the books of such taxpayers, and on refusal to allow an examination, may summon such person or corporation to produce the books and to appear before them to give testimony or answer interrogatories under oath respecting the matter.[7] Collectors may make returns for taxpayers from their own knowledge and from such information as they can obtain through testimony or otherwise in cases where the taxpayer fails to file a return or makes a false or fraudulent return.[8] Appeals may be taken from decisions of Collectors to the Commissioner Internal Revenue.[9]

Revenue Agents and Inspectors. The duties of officers of this class are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make return as required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns, for the purpose of ascertaining and reporting as to whether the law has been complied with, when so ordered by the agent in charge of the division to which they are assigned. Reports of these officers are made to the agent in charge of the division to which they are assigned who in turn reports to the Commissioner of Internal Revenue and the collector of the proper district. In the discharge of their official duties officers of this class are expected to exercise sound discretion, treat all persons with due courtesy, and, while

6 U. S. v. Hodson, 14 Int. Rev. Rec. 100.

7 U. S. Rev. Stats., § 3173.

8 U. S. Rev. Stats., § 3176.

9 See Chap. 39, infra.

acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint.[10]

Rulings and Regulations. For the guidance of collectors and taxpayers the Commissioner of Internal Revenue issues from time to time rulings and regulations on questions which arise in the course of administering the law. They are published under the caption of "Treasury Decisions" and are numbered serially for purpose of reference.[11] At intervals large compilations of rulings and regulations are published by the Bureau of Internal Revenue and these are designated as "Regulations" and given a serial number.[12] In addition to the rulings and regulations the Department issues so-called mimeograph letters to collectors, more or less confidential in their character and not intended for general publication. Frequently such letters throw light on the administration of the law and such mimeograph letters as have been made public are referred to in this book.

RETROACTIVE EFFECT OF RULINGS. Generally speaking any ruling or regulation made by the Treasury Department supersedes all prior rulings and regulations and is retroactive to the time the law was enacted, since a ruling or regulation is merely an interpretation of the meaning of the law, and in theory the meaning has been the

10 T. D. 1932.

11 Treasury decisions contain rulings on all subjects over which the Bureau of Internal Revenue has jurisdiction. Those relating to the income tax are therefore not numbered in sequence. Reference to treasury decisions is usually made by employing the abbreviation, thus, "T. D. 2476."

12 The last general compilation of rulings on the income tax is known as "Regulations No. 33" issued January 5, 1914.

same from the beginning. The Treasury Department recognizes, however, that in some instances it would be unjust or impracticable to reopen returns, adjustments or assessments which have been made in accordance with previous rulings and, where such rulings are superseded, an express limitation is made in the superseding ruling or regulation as to the retroactive effect thereof.[13]

Construction of the Law. A statute may be construed contrary to its literal meaning when a literal construction would result in an absurdity or inconsistency, and the words are susceptible of another construction which carries out the manifest intention, but it is a well settled rule of interpretation that a legislative act is to be interpreted according to the intention of the legislature apparent upon its face,[14] and consequently the statements made in debate at the time of the passage of the law have no particular value in construing the act. Revenue laws are not, like penal laws, to be construed strictly in favor of the defendants. They are rather to be regarded as remedial in their character and so construed as to carry out the intention of the legislature in passing them.[15] As a general rule, the construction by the Treasury Department is such as is most favorable to the enforcement of the laws and no liberal interpretation in favor of the individual is indulged in.[16] The courts construe such statutes with reasonable fairness to

13 See last paragraph of mimeograph letter to collectors dated August 14, 1914; I T S 1917, ¶ 264; also the last paragraph of T. D. 2313 and T. D. 2317.

14 Wilkinson v. Deland, 2 Pet. 627; U. S. v. Union Pacific R. R. Co., 91 U. S. 72.

15 U. S. v. Stowell, 133 U. S. 1.

16 18 Op. Atty. Gen. 246.

the citizen,[17] an unjust or absurd construction is avoided [18] and laws of doubtful or double meaning are not too harshly construed. Courts are not at liberty, by construction or legal fiction to include subjects of taxation not within the terms of the law, and duties are never imposed on citizens upon vague or doubtful interpretation.[19] Courts do not extend the provisions of taxing statutes, by implication, beyond the clear import of the language used, or enlarge their operations to embrace matters not specifically pointed out. In case of doubt the statute is construed most strongly against the Government, and in favor of the citizen.[19a] Where the language is dubious and open to different interpretations the construction put upon it by the Treasury Department has a great, and generally a controlling, force with the court, but in order to be binding such construction of the Department must be long continued and unbroken, and the rule has no application where the statute is ambiguous, or where it will not bear the interpretation put upon it by the administrative officers.[20]

Porto Rico and the Philippines. In Porto Rico and the Philippine Islands the law is administered and the

17 U. S. v. Distilled Spirits, 10 Blatch. 428.

18 In re. Chapman, 166 U. S. 661.

19 Hartranft v. Weigmann, 121 U. S. 609, Mutual Benefit Insurance Company v. Herold, 198 Fed. 199.

19a United States v. Wigglesworth, 2 Story 369; American Net and Twine Co. v. Worthington, 141 U. S. 468; Benziger v. United States, 192 U. S. 38; Gould v. Gould, No. 41, Oct. Term, 1917, U. S. Supreme Court—not yet officially reported.

20 St. Paul, etc., Railway Co. v. Phelps, 137 U. S. 528; Merritt v. Cameron, 137 U. S. 542; U. S. v. Hill, 120 U. S. 169; Swift Company v. U. S., 105 U. S. 691; U. S. v. Graham, 110 U. S. 219; U. S. v. Tanner, 147 U. S. 661; U. S. v. Alger, 152 U. S. 384.

tax is collected by the appropriate internal revenue officers of those governments, and the tax so collected accrues intact to the general governments thereof respectively.[21] This does not mean, however, that a separate tax is imposed on income arising in those jurisdictions. If a taxpayer is required under the law to make his return in a collection district located in any state or territory, he pays his tax there on income from all sources, including Porto Rico and the Philippines, and pays no tax in any other district or jurisdiction.[22] The 1917 Law does not extend to Porto Rico and the Philippines, and the legislatures thereof are given power, under the 1917 Law, as amended, to alter, amend or repeal the income tax laws within their respective jurisdictions.[23]

Virgin Islands. The income tax laws have not expressly been made applicable to the islands recently acquired from Denmark. The words "United States" are defined in the 1916 Law to include any Territory, the District of Columbia, Porto Rico, and the Philippine Islands.[24] Hence, the status of residents of our new possessions is uncertain under the present statutes, as is also the status of residents in other possessions not enumerated in the above definition.[25]

21 Act of September 8, 1916, § 23.

22 Letter from Treasury Department dated April 4, 1917.

23 Act of October 3, 1917, Title I, § 5. Since this power exists it is no longer safe to assume that the laws in those possessions are identical with the federal law.

24 Id., § 15.

25 It seems the inhabitants of those possessions are "non-resident aliens" within the meaning of the term as used in the 1916 Law. See Sec. 1 (a) and Sec. 15.

Reporting Net Income. Taxpayers are required to file annually a report (referred to in the law and the regulations as a return of net income) showing the amount of taxable income received, the deductions and exemptions claimed, and the net income upon which the tax is to be imposed. This return is filed in the collection district in which the taxpayer resides or has his principal place of business. Non-residents having no place of business in this country file their returns with the collector of internal revenue at Baltimore, Maryland.[26] The tax is paid in the district in which the return is filed. The return of annual net income is filed by individuals on or before March 1 in each year. In it is reported the income received during the preceding calendar year. Corporations also file an annual return at the same time, and for the same period, except those corporations which have elected to report for their fiscal years instead of the calendar year, in which case the return is filed within sixty days after the close of the fiscal year.[27] Partnerships, as such, file no annual returns.[28]

Individuals. No person whose net income is less than $1,000 in any calendar year is required to file a return for that year. Unmarried persons receiving $1,000 or more net income during the calendar year, and married persons receiving $2,000 or more net income during the same period, are required to file the annual

26 This district is the one in which Washington, the national capital, is located.

27 See Chapter 12.

28 See Chapter 10.

return, although after deducting the personal exemptions to which they are entitled no tax may be due.[29]

PERSONAL EXEMPTION. The personal exemption is an arbitrary amount of net income on which residents and citizens are not taxed. It may be said to be an amount allowed for personal or family expenses, the actual amount of such expenses not being deductible from gross income in the annual return. Non-resident aliens are not entitled to claim any personal exemption, but are taxed on their entire net income from sources within this country. Corporations, also, are not allowed any exemption, but are taxed upon their entire net income whatever the amount may be. The amount of personal exemption allowed depends upon the status of the individual. Under the 1916 Law single persons are entitled to an exemption of $3,000, married persons living together, and heads of families whether married or not, are entitled to an aggregate exemption of $4,000. Under the 1917 Law the personal exemptions are $1,000 and $2,000, respectively. Under each law an additional exemption of $200 is allowed to the head of the family for each child dependent upon him, if under eighteen years of age, or of any age if the child is incapable of self-support because mentally or physically defective. The personal exemption may be deducted only in computing the normal tax, which is imposed upon the entire net income of the individual over and above such exemption. Since the income tax is assessed under two separate laws with different rates and different exemptions, each individual is entitled to two personal exemptions but this does not mean that he is entitled to the sum of the two, that is

29 See Chapter 5 as to requirements for filing returns in the case of non-resident aliens.

to say, while a single person is entitled to a personal exemption of $3,000 under the 1916 Law and $1,000 under the 1917 Law, this does not give him a total exemption of $4,000. Each exemption is used only in computing the tax due under the law to which it applies and has no application to the other law.[30]

Normal Tax. In the case of individuals a normal tax of 2% is payable on the entire net income of the individual, over and above the exemptions, under each law, making in the case of single persons a total normal tax of 4% on all incomes over $3,000 and a normal tax of 2% of the amount between $1,000 and $3,000. In the case of married persons and heads of families the total normal tax is 4% on all income over $4,000 and 2% on the income between $2,000 and $4,000. Non-resident alien individuals are subject only to the 2% normal tax imposed by the 1916 Law, the normal tax imposed by the 1917 Law being expressly limited to citizens and residents of this country.

Supertax. In addition to the normal tax payable under each law a supertax is imposed under the 1916 Law on all incomes over $20,000. The supertax is graduated so as to bear more heavily as the amount of net income increases. Under the 1917 Law the supertax commences at $5,000. The law refers to the supertax as the "additional tax" but for the sake of clearness the tax will be referred to in this book as the supertax. The supertax is assessed on the entire net income of each individual, in excess of the minimum amounts, but on the separate, not combined, incomes of husband and wife. While in the case of non-resident aliens only one normal tax is

30 For a further discussion of the personal exemption see the chapter on citizens and residents.

assessed, the supertaxes of both the 1916 Law and the 1917 Law are applicable to them with respect to their entire net income received from sources within the United States in excess of $20,000 and $5,000, respectively.[31]

Corporation Tax. The rate of tax imposed upon the net income of corporations is 2% under the 1916 Law and 4% under the 1917 Law making a total of 6%. This total rate applies to all corporations, whether domestic or foreign, and to all amounts of income no matter how large or how small, except that for the purpose of computing the amount of net income under the 1917 Law dividends received by one corporation on the stock of another corporation may be deducted, but in determining the net income for the 1916 Law such dividends must be included.[32]

Collection of the Tax at the Source. Collection at the source, deduction at the source, withholding at the source and stoppage at the source, are synonymous terms meaning that the one paying income to another deducts or withholds an amount equal to the tax on the sum so paid and turns it over to the Government to the credit of the one against whom it was withheld. This method is used in order to facilitate the collection of the tax and to prevent evasion. Collection at the source applies at the present time only to (a) payments of fixed and determinable annual or periodical income to non-resident alien individuals, (b) payments of interest on bonds and similar obligations of domestic corporations to non-

[31] See Chapter 2 for further statement of the rates of tax.

[32] For a further discussion of this subject see Chapter 12 on corporations.

resident foreign partnerships and non-resident foreign corporations, (c) payments of dividends to non-resident foreign corporations and (d) payments of interest on bonds and similar obligations of corporations, if such bonds contain a so-called "tax-free covenant" which requires the corporation to assume the burden of the tax which it may be required to withhold or deduct from the interest paid to its bondholders.[33] In the last of the aforementioned cases deduction applies whether the recipient of the income is a citizen or alien, resident or non-resident. With this exception no withholding is required against citizens and residents of this country.

Information at the Source. For the purpose of checking up the returns of taxpayers the law provides for a system of information at the source whereby every corporation may be required to report to the Commissioner of Internal Revenue the names and addresses of its stockholders and the amount of dividends paid to each; stockbrokers may also be required, when called upon, to report the names and addresses of customers and information as to the profits and losses of each, and all persons, corporations or partnerships may be required to report the names and addresses of any persons to whom they pay fixed or determinable gains, profits or income of $800 or more in any taxable year. In the case of payments of interest to the bondholders of corporations the names and addresses of such bondholders are required to be reported regardless of the amount paid during the year as is also the rule in the case of collection of foreign items of interest and dividends.[34]

[33] See Chapter 41 on Collection at the Source.

[34] For a further discussion of this subject see the chapter on Information at the Source.

Tax Due. The income tax is due and payable ordinarily on the 15th day of June following the filing of the return of annual net income, but may be paid without penalty within ten days after demand for payment has been made by the local collector. Since demand for payment cannot be made before the due date, the tax may be paid without penalty within ten days thereafter, and this period of grace is extended if the collector fails to make a prompt demand. In the case of corporations reporting for their fiscal year the tax is due and payable one hundred and five days after the date on which the return is required to be filed, that is, within one hundred and sixty-five days after the close of the fiscal year, with a like period of grace of ten days after demand for the tax has been made. The tax may be paid in advance in instalments if the taxpayer chooses to do so, and in such cases the Secretary of the Treasury may allow a discount at a rate not exceeding 3% per annum.[35]

Abatement and Refund. The collection of the income tax cannot be restrained by injunction, but if taxes have been erroneously or illegally assessed or collected, the Commissioner of Internal Revenue is authorized to remit and pay back the amount to the taxpayer. The importance of collecting revenue is so great that the law permits no taxpayer to interpose a hindrance to the orderly assessment of the tax. He must allow the assessment to be made and may thereafter claim abatement or refund by filing a claim with the local collector.[36]

35 For a further discussion of this subject see Chapter 36 on assessment and payment of the tax.

36 See Chapter 39 for procedure as to abatement and refund.

CHAPTER 2

THE INDIVIDUAL TAX RATES

As indicated in the foregoing chapter the income tax is at present assessed and collected under two laws. The amount of tax to which each individual is liable is computed separately under each law and the two amounts are added together to determine his total liability. Each law prescribes a fixed rate, known as the normal tax, and a series of graduated rates, known as the additional tax, supertax or surtax. In the case of corporations no supertax is imposed, the rate being uniform on all amounts of net income.

Normal Tax. Under the 1916 Law a normal tax of 2% is imposed upon the entire net income received during the taxable year from all sources by every individual a citizen or resident of the United States, and upon the entire net income received during the taxable year from all sources within the United States by every individual, a non-resident alien, including interest on bonds, notes and other interest-bearing obligations of residents, corporate or otherwise. Under the 1917 Law a normal tax of 2% is imposed upon the net income of every individual, a citizen or resident of the United States, received in the calendar year 1917 and every calendar year thereafter. A citizen of the United States, wherever he may reside, is subject to both normal taxes.

An alien is subject to both normal taxes if he resides in this country, but only to the 2% normal tax under the 1916 Law if he resides outside this country. In assessing the normal tax under the 1916 Law, the personal exemption allowed under that law is first deducted from the net income, and similarly in assessing the normal tax under the 1917 Law the personal exemption allowed under that law is first deducted. On all the net income in excess of the exemptions the normal rate applies.

Supertax. In addition to the normal tax a supertax, called in the law "the additional tax" is imposed at various rates under the 1916 Law and the 1917 Law. For the purpose of assessing the supertax the personal exemptions are not deducted. The rates are as follows:

On the amount by which the total net income

Exceeds	But does not Exceed	1916 Law.	1917 Law.
$ 5,000	7,500	None	1%
7,500	10,000	None	2%
10,000	12,500	None	3%
12,500	15,000	None	4%
15,000	20,000	None	5%
20,000	40,000	1%	7%
40,000	60,000	2%	10%
60,000	80,000	3%	14%
80,000	100,000	4%	18%
100,000	150,000	5%	22%
150,000	200,000	6%	25%
200,000	250,000	7%	30%
250,000	300,000	8%	34%
300,000	500,000	9%	37%
500,000	750,000	10%	40%

On the amount by which the total net income

Exceeds	But does not Exceed	1916 Law.	1917 Law.
750,000	1,000,000	10%	45%
1,000,000	1,500,000	11%	50%
1,500,000	2,000,000	12%	50%
Over 2,000,000		13%	50%

COMPUTING THE TAX—ILLUSTRATION. The tax on a married person with a net income of $50,000 for the year is computed as follows:

		1916 Law.		1917 Law.	
Normal Tax:					
$50,000 minus $4,000 (personal exemption) equals $46,000 at..............		2%	$920		
$50,000 minus $2,000 (personal exemption) equals 48,000, at..............				2%	$960
Supertax					
On first	$ 5,000		0		0
On next	2,500		0	1%	25
($5,000 to $7,500) On next	2,500		0	2%	50
($7,500 to $10,000) On next	2,500		0	3%	75
($10,000 to $12,500) On next	2,500		0	4%	100
($12,500 to $15,000) On next	5,000		0	5%	250
($15,000 to $20,000) On next	20,000	1%	200	7%	1,400
($20,000 to $40,000) On next	10,000	2%	200	10%	1,000
($40,000 to $50,000)					
Totals	$50,000		$1,320		$3,860
					1,320
Total income taxe due...............					$5,180

The tax on an unmarried person would be increased by 2% on $2,000, or $40, since the personal exemption is $1,000 less under each law. In case a married person or the head of a family is entitled to further exemption because of dependent children, the normal tax will be reduced at the rate of $8 for each such child, that is, 2% on $200 under each law.

Husband and Wife. Where a husband and wife make returns of their joint incomes the supertax is not computed on the joint income of both, but on the separate income of each, although the incomes of both may be reported on the same return.[1]

Supertax on Stockholders in Respect of Undistributed Profits of Corporations. The supertax is ordinarily assessed only upon the income actually received by the taxpayer but where an individual forms or fraudulently avails himself of a corporation for the purpose of preventing the imposition of the supertax through the medium of permitting the gains and profits of such corporation to accumulate, instead of being divided or distributed, the law provides that for the purpose of the supertax the taxable income of such individual shall include the share to which he would be entitled of the gains and profits of such corporation if they were divided or distributed. This provision applies only where the accumulation is permitted for the purpose of fraudulently avoiding the supertax. Ordinarily, the stockholder of a corporation has no need to concern himself with this provision or to make any inquiry as to the undistributed income of the corporation.[2] If a cor-

1 T. D. 2090; T. D. 2137.
2 T. D. 2135.

poration is a mere holding company, or the gains and profits are permitted to accumulate beyond the reasonable needs of the business, that fact is *prima facie* evidence of a fraudulent purpose on the part of the stockholders to escape the supertax. Neither the collectors nor the Commissioner of Internal Revenue, however, have any authority to decide when the surplus or undivided profits of a corporation are accumulated beyond the reasonable needs of the business, and therefore taxable under this provision as though distributed. The Secretary of the Treasury must first certify that in his opinion the accumulation is unreasonable. When he has so certified the stockholders are notified thereof and called upon to add the amount of their respective shares in the undistributed gains and profits of the corporation for the year to their income from other sources and to pay the supertax accordingly.[3]

[3] Act of September 8, 1916, § 3.

CHAPTER 3

INDIVIDUALS TO WHOM THE LAW IS APPLICABLE

The theory upon which the tax is imposed seems to be two-fold. The law imposes the tax upon the entire net income of all persons within its jurisdiction, regardless of where the income arises, and on all income arising in the United States, regardless of whether or not the United States has jurisdiction of the person who receives it. The tax has been defined as a tax on the person, measured by his ability to pay, that is, his net income,[1] and as a tax on the income itself.[2] As a matter of fact, it is both. The Government claims personal jurisdiction over all of its citizens wherever they reside and over all aliens who reside within its borders. Hence, as to citizens and resident aliens, the tax is imposed on income from all sources whether arising in this country or in a foreign country. No jurisdiction can be claimed over the persons of non-resident aliens, but so far as their income is received from sources in this country it is taxed on the theory that the Government has jurisdiction

1 In Brady v. Anderson, 240 Fed. 665, the court said: "In our opinion the tax is against citizens and residents of the United States personally. They are chargeable in respect to income received by them."

2 In a case decided by the Supreme Judicial Court of Massachusetts, Suter v. Jordan-Marsh Company, 113 N. E. 580, it was held that the tax was levied upon the rent paid by the defendant to the plaintiff.

over the income, grants protection to the creation of such income, and is, therefore, entitled to a share thereof to defray the expenses of government. The fact that a person is taxable in foreign countries on all or part of his income does not relieve him for that reason from tax liability on the same income in this country.[3]

Persons Exempt from the Tax. The only citizens or residents who are exempt from all requirements of the law are those receiving less than $1,000 of income during the year, if unmarried, or less than $2,000, if married. Non-resident aliens are not exempt no matter how small the income, provided it is received from sources within this country. Individuals may, however, enjoy an exemption from the tax because of the character of the income they receive, since the law expressly provides that certain kinds of income shall not be subject to the tax. Among the items of income so exempt are the proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; the amount received by the insured as a return of premiums paid by him under life insurance, endowment, or annuity contracts, property acquired by gift, bequest, devise, or descent (but the income from such property is taxable), interest on the obligations of a State or any political subdivision thereof or upon the obligations of the United States (to the extent provided in the Act authorizing the issue, if the bonds are issued after September 1, 1917), or its possessions or securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; and the compensation of all officers and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States Govern-

[3] T. D. 2152.

ment. Under these provisions officers and employees of a state, city or county, including public school teachers, etc., are exempt from the tax to the extent that their income is derived from salaries paid by the state, county or city. They enjoy, however, no exemption from tax on income from taxable sources merely because of their position as employees of a state. The Act also exempts from tax the compensation of the present President of the United States during the term for which he has been elected and the judges of the Supreme Court and inferior courts of the United States in office at the time the Act was passed. Exempt income is omitted from the returns of annual net income of individuals but is required to be reported by corporations.

Citizens of the United States. For the purpose of the income tax law no distinction is made between native and naturalized citizens. They are taxable upon their entire net income from all sources whether they reside within this country or not. Married women are considered to have the same citizenship as their husbands. An American woman who marries a foreigner consequently loses her status as an American citizen and is thereafter treated as an alien.[4] But determination by the State Department of the status of an individual is not conclusive upon the Treasury Department in fixing citizenship for income tax purposes.[5]

Residing in the United States. Citizens residing in the United States report and pay the tax in the district in which they reside or have their principal place of business, regardless of where the income may arise.

[4] T. D. 2092.
[5] T. D. 2135.

Residing Abroad. If a citizen residing abroad has no office or place of business in this country he files his return and pays his tax to the Collector of Internal Revenue at Baltimore, Maryland. He is, of course, required to report his income from all sources whether within or without the United States. Although the question as to the liability of a non-resident citizen is not determined by the State Department but by the Treasury Department, still, in the case of a naturalized citizen against whom the presumption of expatriation has arisen, the fact that he has paid the income tax will receive due consideration by the State Department in connection with other evidence submitted to overcome such presumption in connection with applications for passports or for registration in a consulate or for actual protection in a foreign country. The payment of the income tax will also be duly considered by the State Department in passing upon rights to the continued protection of this Government in cases of native American citizens who have resided abroad for a period so long that the natural presumption may be held to have arisen that they have abandoned citizenship in this country.[6]

Aliens Residing in the United States. The question of whether or not an alien resides in this country is sometimes difficult to determine. The Treasury Department has held that where for business purposes or otherwise an alien is permanently located in the United States, has there his principal business establishment and is there permanently occupied or employed, even though his domicile may be without the United States,

[6] Letter from Secretary of State to American Diplomatic and Consular Officers, dated March 18, 1914.

he will be held to be residing in the United States. On the other hand an alien physically present in the United States, but only temporarily residing or employed here (as for a season or other similiar definite term) and with the expectation of leaving the United States upon the termination of employment or accomplishment of the purpose which necessitates his presence in the United States, will be considered a non-resident.[7] The Treasury Department has adopted the following definition of the word "residence" as used in the income tax laws: "That place where a man has his true, fixed and permanent home and principal establishment, and to which, whenever he is absent, he has the intention of returning; and indicates permanency of occupation as distinct from lodging or boarding, or temporary occupation."[8] Aliens coming into the United States with the intention of becoming residents may establish that fact and have the privilege of resident aliens under the statute, by filing a certificate[9] with the withholding agents charged with the duty of withholding the tax on income paid to non-resident aliens.

Non-Resident Aliens. Non-resident aliens are those persons who are neither citizens nor residents of this country. As stated above, they are taxable only to the extent of the income they derive from sources

7 This rule differs from the English rule which provides that a person within the United Kingdom for some temporary purpose only for less than six months during the year is not taxable as a resident but after a residence of six months he becomes chargeable with the duties for the year commencing on April 6th preceding.

8 T. D. 2242.

9 T. D. 2242. The certificate to be used is known officially as Form 1078.

within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise. If a non-resident alien conducts business through an agent in this country, the agent will be subject to the duty of filing a return for his non-resident principal and of paying both the normal and the supertaxes.[10]

Husband and Wife. In so far as possible the family is treated as a unit for the purpose of the income tax, and husband and wife are required to make joint returns unless they have separate estates. The personal exemption is in such cases deducted from the joint income, but the surtax is in all cases imposed upon the separate incomes.[11]

Minors. Minors are unable to make returns for themselves, and such returns are required to be made by their guardians.[12] If the minor has a separate legal estate a separate return is made of his income, but where a minor child has received gifts of money and other property from relatives and the property has been invested on behalf of the child by the father, although he has not been legally appointed guardian, the amount should be included in the return made by the father as a part of his (the father's) income.[13]

10 See Chapter 6 on agents for non-resident aliens.

11 T. D. 2090.

12 Reg. 33, Art. 17.

13 Letter from Treasury Department dated October 20, 1916; I. T. S. 1917, ¶ 248. This ruling is made apparently to prevent evasion of the law by distributing the income of the parent among his minor children.

Incompetents. Incompetent or insane persons are unable to make their own returns of net income, and the same are required to be made by the duly authorized agent, guardian or committee having charge of such incompetent or insane person.[14]

Absentees. Where a persons is absent from the country or is a non-resident and is unable to make the return of annual net income it may be made for him by an agent, the agent assuming the responsibility of making the return and incurring penalties provided for erroneous, false or fraudulent returns.[15]

Agents. Any person duly authorized and having knowledge of the income of another may file returns for his principal and pay the tax based thereon. The intent and purpose of the act is "that all gains, profits and income of a taxable class," as defined by the law, shall be charged and assessed with the corresponding tax, normal and supertax, prescribed by the law, and the tax shall be paid by the owner of such income or the proper representative having the receipt, custody, control or disposal of the same.[16] Persons having the control and custody of income of non-resident aliens may, without having been appointed by the principal, be charged with the duty of making a return and paying the tax on the income passing through their hands.[17]

Fiduciaries. Trustees, executors, administrators and other persons acting in a fiduciary capacity are charged

14 Reg. 33, Art. 17.
15 Act of September 8, 1916, § 8 (b).
16 Act of September 8, 1916, § 9 (g).
17 See Chapter 6 for duties of agents of non-residents.

with special duties under the law. These duties are fully discussed in the chapter on fiduciaries.[18]

Persons Dying During the Year. When a person dies during any calendar year it is the duty of the executor or administrator or person taking charge of his property to make a return for the deceased from the beginning of the year to the date of death. In this return should be reported all of the income received up to the time of death and all the allowable deductions incurred up to that time. The personal exemption may be claimed in full according to the status of the decedent and regardless of the length of time during the year in which he lived. In case the decedent dies after the close of the calendar year, but before March 1st of the following year, and has not made a return for the preceding calendar year a return should be made for the full year preceding and in addition a return from January 1 of the current year to the date of death. If during the period in which the decedent lived he was not in receipt of $1,000 of net income, if unmarried, or $2,000, if married, no return need be filed, unless he was a non-resident alien, in which case a return should be filed, whether married or single, if the amount is $1,000 or more. The fact that a person may have died before the passage of the law does not relieve his estate of liability for tax, if he lived during any part of the time after the incidence of the tax. Thus a person dying after March 1, 1913, but before October 3, 1913, the date on which the 1913 Law was passed, was held to be taxable thereunder. The effect of making the act retroactive is to apply it to him

18 See Chapter 8.

exactly as if it had been enacted on March 1, 1913.[19] Similarly if a person dies at any time after the 1st of January, 1917, his estate will be subject to the tax imposed by the 1917 Law.

19 Brady v. Anderson, 240 Fed. 665.

CHAPTER 4

CITIZENS AND RESIDENTS OF THE UNITED STATES

All citizens of this country, residing here or elsewhere, and all residents of this country, whether citizens or not, are classed together for the purpose of the income tax.[1]

Extent to Which Taxable. Citizens and residents are taxable upon their entire net income received in each calendar year from all sources, except income declared by the law to be exempt. On dividends of corporations taxable under the act they are liable only for supertaxes. The regulations and rulings respecting taxable and non-taxable income are applicable to both individuals and corporations and are discussed in the later chapters on income.[2]

Deductions and Exemptions Allowed. Citizens and residents are allowed the following deductions in computing net income for the purpose of the tax. Many of the deductions are the same as those permitted to corporations and in such cases the deduction is fully discussed in a subsequent chapter. In this chapter only the special provisions applicable to individuals are discussed at length.

1 See preceding Chapter for definition of citizens and residents.
2 See Chapters 16 to 26 on income.

Business Expenses. An individual may deduct from his gross income all necessary expenses actually paid in carrying on any business or trade but may not deduct personal living or family expenses.[3] A subsequent paragraph of this chapter defines what is held by the Department to be the meaning of the words "business or trade."

BUILDINGS USED FOR RENTAL PURPOSES. A landlord may claim as an expense any amounts for maintenance of the property or its use for rental purposes, including amounts paid for repairs, insurance, fuel, light and water, and janitor and elevator service, if any.[4] Where the landlord occupies a part of the building as his own dwelling he should not deduct such proportion of the expenses of operating the building as inure to his personal benefit, as that part constitutes personal or living expenses which are not deductible. Thus, if a landlord lives in one-half of the building, one-half of the expenses are not allowable deductions in his return.

PERSONAL LIVING OR FAMILY EXPENSES. The personal living or family expenses which are not deductible under the law are intended to be those which are not incurred by the taxpayer in carrying on his business or trade. They include, for example, the expense of maintaining his home, payments to his servants, payments for the support and education of his children. Premiums paid for insurance on property occupied by the owner as a dwelling are a personal expense and not allowed as

[3] The personal exemptions may be said to be an arbitrary sum allowed for such expenses.

[4] Letter from Treasury Department dated February 26, 1915; I. T. S. 1917, ¶ 224.

a deduction. Premiums paid on life insurance by the insured are also not allowed as a deduction.[5] Alimony is regarded as a personal expense and is not an allowable deduction.[6]

Interest. A citizen or resident may, with one exception, deduct all interest paid within the year on his indebtedness.[7] This includes not only indebtedness incurred for business purposes, but indebtedness incurred for any purpose, such as for the purpose of buying a dwelling house or any article or thing of personal use. The one limitation on the amount of interest which may be deducted is with respect to interest paid on indebtedness incurred for the purchase of obligations or securities, the interest upon which is exempt from taxation as income of the individual.[8]

Taxes. Citizens or residents may deduct all taxes paid within the year imposed by the authority of any territory or possession of the United States, or any foreign country, or under the authority of any state, county, school district or municipality or other taxing subdivision of any state. Taxes assessed against local benefits, however, may not be deducted. Taxes imposed by the United States may be deducted, except income taxes and excess profits taxes. Inheritance taxes are held not to be taxes contemplated by this provision of the law.[9]

5 T. D. 2090.

6 T. D. 2090..

7 Telegram from Treasury Department dated February 16, 1915.

8 For a further discussion of this subject see Chapter 29.

9 For a further discussion of the rules relating to the deduction of taxes see Chapter 30.

Losses Incurred in Trade. Citizens and residents may deduct losses actually sustained during the year incurred in business or trade. A loss incurred in business or trade must be an absolute loss, not a speculative or fluctuating valuation of a continuing investment, but must be determined and ascertained upon an actual, a completed, a closed transaction.[10]

BUSINESS OR TRADE. Business or trade has been defined as being synonymous terms and to be "That which occupies and engages the time, attention and labor of anyone for the purpose of livelihood, profit, or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment." The doing of a single act incidentally or of necessity not pertaining to the particular business of the person doing the same will not be considered engaging in or carrying on business.[11] "In trade" as used in the law is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money, otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may be engaged in more than one trade and may deduct losses incurred in all of them, provided that in each trade the above requirements are met. Losses on stocks, grain, cotton, etc., may be deducted by a person engaged in the trade to which the buying or selling thereof are incident as a part of the business, as by a member of a stock, grain, or cotton exchange,[12] but

10 T. D. 1989. Depreciation in the value of property is treated as a separate deduction and should not be confused with loss.

11 T. D. 1989.

12 T. D. 2090.

neither the investment of money in the stock of a company nor employment by the company in any official capacity makes the business of the company the trade of the investor or employee.[13] The losses which seem to be limited by this provision of the law are those incurred in transactions involving sales or dealings in property. The law seems clearly to make a distinction between such losses and losses arising from fires, storms, shipwreck, or other casualty, and from theft.

Losses of Property from Fire, Storms, Etc. The law does not require that the property lost by fires, storms, shipwreck, or other casualty, or from theft, should be properly employed in the business or trade of the individual, but the Treasury Department seems to hold that even such losses must be sustained in trade.[14] It seems to have been the intent of Congress, however, to permit the deduction of these losses by citizens or residents to the extent that the losses are not compensated for by insurance or otherwise.[15]

Losses Not Incurred in Trade. In transactions entered into for profit but not connected with his business or trade, a citizen or resident may deduct the losses

13 T. D. 2135. This extremely narrow construction of the language of the law has perhaps been the subject of more criticism than any other ruling of the Treasury Department. It operates to the detriment of every person who invests or speculates in property. Notwithstanding the criticism, however, Congress has not seen fit to remedy the injustice by permitting the deduction of all losses in transactions on which the gain, if any, is taxable.

14 T. D. 2005.

15 Act of September 8, 1916, § 5 (a). For a further discussion of the subject of losses see Chapter 31.

actually sustained therein during the year to an amount not exceeding the profits arising therefrom. The loss must be actually sustained during the year and the total amount which may be deducted shall not exceed the profits arising from the same class of transactions.[16] Under this heading an individual who makes investments in property from time to time, or who speculates, is required to report all of the gains from such investments or speculations and may offset against the gains all losses which he has sustained in similar transactions. He is thus required to report only the net gain from such transactions during the year. If, however, the net result for the year of a series of such transactions is a loss, he is not entitled to offset the loss against his income from buiness or trade.[17]

Worthless Debts. A citizen or resident may deduct all debts due to him actually ascertained to be worthless and charged off within the year. The law does not require such debts to have been incurred in the business or trade of the individual. It is sufficient if a debt was legally due and owing to the taxpayer, has actually

16 Act of September 8, 1916, § 5.

17 Prior to the passage of the Act of September 8, 1916, authorizing the deduction of losses not incurred in trade to the extent indicated above, it was held by the Treasury Department that an individual was required to report all income from transactions not incurred in trade but was not entitled to deduct any of the losses. Thus, if on a series of transactions during the year a gain of $5,000 was made, and $4,000 was lost, the sum of $5,000 was to be reported as income and no deduction could be made for the loss. T. D. 2135. Under the present law the taxpayer pays the tax only upon the net gain of $1,000. Logically, since the law taxes all gains from the sale of capital assets whether or not employed in business or trade, the law ought also to permit a deduction for all losses in the sale of similar assets.

been ascertained to be worthless and has been charged off within the year.[18]

Depreciation. An individual is allowed a reasonable deduction for exhaustion, wear and tear of property arising out of its use or employment in his business or trade. It is to be noted that this deduction applies expressly to property used in the individual's business or trade. No allowance for depreciation can be claimed upon other property, such as the individual's residence or his pleasure automobile. This limitation applies expressly to individuals. In other respects the provisions for allowing depreciation in the case of individuals and corporations are the same, and are treated in a subsequent chapter on depreciation.[19]

Depletion of Natural Resources. Individuals are permitted the same allowance for the exhaustion of natural resources as is allowed to corporations in the case of oil wells, gas wells and mines. This subject is discussed in subsequent chapters.[20]

Improvements and Betterments. No deduction is allowed for amounts expended for new buildings, permanent improvements or betterments made to increase the value of any property or estate and no deduction is allowed for any amount expended for restoring property or making good the exhaustion thereof for which an allowance has been made. This limitation on the deductions allowed to individuals is the same as in the

18 See Chapter 31 for a further discussion on the deduction of worthless debts.

19 See Chapter 32 on Depreciation.

20 See Chapters 33 and 34.

case of corporations, and is a reasonable limitation. Amounts of capital invested in permanent improvements or betterments add to the value of the property. If such property is subject to wear and tear or depletion the additional amount so invested in the property may be taken into consideration in computing the allowance for depreciation or depletion. This subject is more fully discussed in a subsequent chapter.[21]

Contributions to Charities. A citizen or resident is allowed to deduct from his net income contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual. This deduction, however, is limited to an amount not in excess of 15% of the taxpayer's taxable net income including the amount of such contributions. The law further provides that such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Treasury Department. The deduction is not allowed to non-resident aliens or corporations.[22]

Credit of Dividends. For the purpose of computing the normal tax the individual may also deduct from his net income the amount received as dividends upon the stock or from the net earnings of any corporation taxable upon its net income under the law. The dividends intended to be included in this provision of the law are

[21] See Chapter 27.

[22] Act of Sept. 8, 1916, as amended, § 5.

apparently those of domestic corporations and also those of foreign corporations, if the foreign corporation is within this country and is taxable upon its net income. The amount of such dividends is deductible only for the purpose of assessing the normal tax, and not for the supertax.[23]

Personal Exemption. The personal exemption is allowed only to citizens and residents. A non-resident alien or a corporation has no right to claim this exemption. In the case of unmarried citizens or residents the amount of the exemption is $3,000 under the 1916 Law, and $1,000 under the 1917 Law. In the case of married persons living together, the exemption is $4,000, under the 1916 Law and $2,000 under the 1917 Law. In the case of the head of a family it is also $4,000 and $2,000 under the respective laws. If the person making the return is the head of a family there is an additional exemption of $200 for each child dependent upon such person, if under 18 years of age, or if incapable of self-support because mentally or physically defective. This deduction, of course, can be claimed only by one parent in a family. The same allowance for dependent children may be claimed under each law.[24]

GUARDIANS AND TRUSTEES. Guardians or trustees are allowed this personal exemption, as to income derived from the property of which such guardian or trustee has charge, in favor of each ward or *cestui que trust*, the amount of exemption depending, of course, on the single or married status of the ward or *cestui que trust* and the existence of dependent children. In no event,

[23] Act of September 8, 1916, Sec. 5 (b).

[24] Act of September 8, 1916, § 7, as amended. T. D. 2547.

however, is a ward or *cestui que trust* allowed a greater personal exemption than is provided in the law from the amount of net income received from all sources. That is, if such ward or beneficiary claims the personal exemption through the trustee it cannot again be claimed against the income from other sources.

ESTATES OF DECEASED PERSONS. In the case of estates of deceased citizens or residents of the United States a specific exemption is allowed, in addition to the other deductions, during the period of administration or settlement. That is, from the net income of each year during which the estate is in the course of settlement, and is consequently taxed as an entity, a specific exemption of $3,000 may be deducted in addition to all other deductions, for the purpose of assessing the 1916 normal tax and $1,000 the purpose of assessing 1917 tax.

TRUSTS AND OTHER ESTATES. Trusts or other estates of citizens or residents of the United States are required, through the trustees, to pay a tax upon all undistributed income. From the amount of such undistributed income, may be deducted a specific exemption of $3,000, for the purpose of assessing the 1916 normal tax and $1,000 for the purpose of assessing the 1917 normal tax.

HEAD OF FAMILY. This phrase in the law is defined to include any person who actually supports and maintains one or more individuals who are closely connected with him (or her) by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation.[25]

25 T. D. 2427.

Such head of a family is entitled to the same personal exemption as married persons. As indicated by the above definition the head of a family may be a single or married person, a widow, widower, brother, sister or other relative by blood, marriage or adoption.

HUSBAND AND WIFE. A husband and wife living together are entitled under the 1916 Law to an exemption of $4,000 only, and under the 1917 Law to an exemption of $2,000 only, from the aggregate net income of both.[26] If they live apart each may claim the exemptions allowed to single persons. The personal exemption may be claimed in a separate return of either husband or wife, the other claiming no exemption; or may be prorated between the two.[27]

STATUS OF CLAIMANT. The status (single, married or head of a family) of the person claiming the personal exemption is determined as of the close of the year.[28] Thus where either husband or wife dies during the year, the survivor, in making a return at the end of the year, will be allowed the exemption applicable to single persons or heads of families, and the executor or administrator of the deceased, in making a return for the deceased, may claim the exemption according to the status of the deceased at the time of his death, from the net income received between the first of the year and the date of death no matter how short the period.[29] The personal exemption is not prorated where a return is made for a period shorter than the full year.

26 Reg. 33, Art 10.
27 T. D. 2137.
28 Reg. 33, Art. 10.
29 T. D. 2090, T. D. 2135.

NOT APPLICABLE TO SUPERTAX. The personal exemption is not to be deducted from the net income of the individual in assessing the supertax.[30]

Tax Not Withheld at Source. The tax is not withheld at the source on payments to citizens and residents. A provision of the law requires withholding at the source in the case of corporate bonds and mortgages containing a so-called "tax-free covenant." This, however, is not intended as a provision requiring withholding, but is intended to require the corporation to assume the burden of a part of the tax for the bondholder. Consequently in such cases no tax is actually deducted, but the corporation assumes for the bondholder the payment of one 2% normal tax, which amount the bondholder reports as though the tax had been actually withheld. The other 2% normal tax being reported as not having been withheld. For a further discussion of collection at the source see the chapter on that subject.[31]

Duty in Making Payment of Income. All citizens and residents are subject to the provisions of law requiring the reporting of names and addresses of individuals to whom fixed and determinable income is paid. For a further discussion of the duties in this connection see the chapter on Information at the Source. If payments of fixed or determinable income are made to nonresident aliens, the normal tax imposed by the 1916 Law is required to be withheld.[32]

30 Cohen v. Lowe, 234 Fed. 474.

31 See Chapter 41.

32 See Chapters 40 and 41.

CHAPTER 5

NON-RESIDENT ALIENS

The law imposes a tax on the entire net income received "from all sources within the United States by every individual a non-resident alien, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise."[1] The term "non-resident alien" as used in several places in the law is not defined therein, but clearly refers to individuals only, and not to partnerships, corporations or associations. Ordinarily it is a simple matter to determine whether an individual is or is not a non-resident alien; he falls into that class if he is neither a citizen nor a resident. Difficulty may arise where a non-resident citizen, naturalized or native, has resided abroad for a period so long as to raise a presumption that he has abandoned his citizenship,[2] and again where an alien has resided in this country for a period so long as to raise a presumption of residence. In either of these cases the intent of the individual is important. The Treasury Department holds that the status of a non-resident native or naturalized citizen remains unchanged until some affirmative action is taken, or the right to

1 Act of September 8, 1916, § 1.

2 The Act of March 2, 1907, provides, briefly, that any American citizen becomes an alien by becoming naturalized in a foreign state or taking an oath of allegiance to any foreign state. A naturalized

citizenship is forfeited by some overt act.[3] The mere fact of continued absence from this country does not, for purpose of income tax, necessarily establish any presumption of expatriation.

On the other hand, an alien coming to the United States with the intention of becoming a resident within the meaning and intent of the income tax statute, may indicate that fact and thereupon will be taxed as a resident, regardless of the length of time he has been here.[4] Where the expectation or intention of an alien is to leave the United States upon the termination of the employment, or accomplishment of the purpose, which necessitates his presence in this country, he will be considered as a non-resident alien although he may temporarily reside here for a season or other similarly definite term.[5] The length of residence is in itself no determining factor, and he may under the present regulations remain in this country during an entire

citizen residing for two years in the country from which he came, or for five years in any other foreign country, is presumed to have renounced his American citizenship in the absence of satisfactory evidence to the contrary. A woman assumes the nationality of her husband, but may resume her original citizenship on becoming a widow; she assumes or retains her American citizenship as a widow if, living abroad, she registers with a United States consul, or without formal action if she resides here. Minor children of naturalized citizens are deemed to be citizens from the time they begin to reside permanently in this country. Children born outside of the United States of citizens, and continuing to reside abroad must at the age of 18 declare their intention as to citizenship. Determination of citizenship by the State Department under this Act is not conclusive upon the Treasury Department; other factors may also be considered, as indicated in the text.

3 T. D. 2135.

4 T. D. 2242. See Chapter 2 for status of resident aliens.

5 T. D. 2242.

tax year without necessarily losing his status as a non-resident alien. Should he go to the extent of locating his principal business establishment here or accept occupation or employment of a permanent character in this country he will be held to be a resident, although his domicile may be without the United States.[6]

Extent to Which Non-Resident Aliens Are Taxable. The 1916 Law provides that non-resident aliens shall pay the normal tax and supertax thereby imposed[7] on their entire net income received from all sources within the United States, including interest on bonds, notes or other interest-bearing obligations, of residents, corporate or otherwise.[8] The 1917 Law imposes no normal tax on non-resident aliens, but imposes a supertax. At present, therefore, a non-resident alien is subject to a normal tax of 2% and two supertaxes—that of the 1916 Law and that of the 1917 Law—on income received from sources within the United States.

Income from Sources Within the United States. The words "sources within the United States" are not defined

6 T. D. 2242.

7 See Chapter 1 for the rates.

8 The 1913 Law which was repealed by the 1916 Law, imposed a tax on the net income of non-resident aliens "from all property owned and every business, trade or profession carried on in the United States." This language was held, under two opinions of the Attorney General, not to include interest or dividends received by non-resident alien investors from domestic corporations, but on March 21, 1916 the Treasury Department reversed this holding and thereafter claimed the tax from non-resident aliens on the classes of income in question. T. D. 2313. In DeGanay v. Lederer, 239 Fed. 568, the District Court held a non-resident alien taxable on such income if the stock certificates and bonds were kept in this country, as then they acquired a situs here for purpose of the income tax. The language of the 1916 Law expressly includes such income, regardless of where the securities may be kept.

in the law and their interpretation raises many difficult questions. The term is very broad and was intended to include income of all kinds from sources over which this country has jurisdiction. No cases as yet have arisen in the courts involving construction of the phrase and the Treasury Department has not issued any comprehensive ruling defining "source." The term "income" includes any income, gains or profits from property owned or business, trade or profession carried on in this country, dividends, interest, royalties, income from property held in trust, income from partnership profits, income from profits or gains on the sale of property, and as further defined in the 1916 Law. Non-resident aliens are not taxed on income specified in the law as exempt.[9]

INCOME FROM BUSINESS BRANCHES. Where a non-resident alien establishes a branch of his business in this country the net income of that branch is subject to tax, and this would seem to be true even though a portion of that income may have been received by the branch from business done in foreign countries, although the precise point is as yet unsettled. If two or more branches are established here, the total net income from all is taken together for purpose of assessment. The income of all branches should be reported by the principal branch in its district, the other branches not being assessable in their respective districts.[10]

DIVIDENDS. Non-resident aliens are not subject to the normal tax on income in the form of dividends of cor-

9 See the Chapters on Income.

10 Generally, the rules applying to foreign corporations as to income from business done in this country apply equally to non-

porations taxable under the law on their net incomes, if a return of annual net income is filed, but the amount of such dividends must be reported in the return. If the total income of all kinds from sources within the United States, including dividends, exceeds $5,000 the supertax imposed by the 1917 Law must be paid at the prescribed rates, and if it exceeds $20,000, the supertax imposed by the 1916 Law must also be paid at the prescribed rates.[11] The exemption of dividends from the normal tax applies not only to dividends received direct from the corporation; but also to dividends received through the medium of fiduciaries or partnerships.[12] Dividends of foreign corporations are not taxable in the hands of non-resident aliens, even though the dividends may be payable in this country.[13] In two provisions of the 1916 Law[14] non-resident aliens are excepted from the requirements to make reports of, or pay supertax on, "such income [income derived from dividends on the capital stock or from the net earnings of any corporation] derived from sources without the United States." The language quoted has not been construed by the courts or in any regulation of the Treasury Department. It undoubtedly applies to dividends received from foreign corporations where the earnings of the corporation are derived from sources without the United States even though the dividends

resident alien individuals. See Chapter 14 on Foreign Corporations.

11 See Chapter 2 for rates.

12 See Chapter 23 for further discussion of this subject.

13 T. D. 2012, T. D. 2030, T. D. 2313, T. D. 2325. Letter from Treasury Department dated April 5, 1916; I. T. S. 1917, ¶ 69. Exemption is claimed from withholding of the tax by using Form 1071 (T. D. 2325) or by using Form 1063 (T. D. 2012).

14 §1 (b) and § 8 (f).

are payable in this country, and there seems to be ground for the contention that it applies with equal force whether the corporation be foreign or domestic.[15]

INTEREST. Non-resident aliens are taxable on all interest on bonds, notes or other interest-bearing obligations of *residents* in this country whether the debtor is a corporation, partnership, or an individual, citizen or alien. Interest received from a non-resident citizen is not taxable. Whether or not interest received from a domestic corporation located entirely outside of this country is taxable is a question still before the Treasury Department for determination.[16] The extent to which

15 Whether Congress intended to give the non-resident alien an exemption from tax on dividends to the extent that such dividends are earned by domestic corporations outside the United States, is not clear, but the language quoted above seems open to a broad construction. The English law recognizes the situation where a British company has permanently located its business and seat of management abroad, and taxes it only with respect to the profits of the English shareholders. Relatively few American corporations are formed to operate entirely outside of the United States, but there are cases where not only does the corporation operate entirely abroad, but also all of its stockholders, directors and creditors are non-resident aliens. It seems reasonable to infer in the absence of express language, that Congress did not intend the tax to apply to the stockholders of such corporations.

16 This point involves the question of residence of the corporation. Generally speaking, under the laws of this county a corporation is a resident of the state in which it is incorporated and cannot migrate to another jurisdiction. If however the word "residence" is given its ordinary meaning, a domestic corporation having its business and seat of management permanently located abroad would seem to be a "non-resident." The Treasury Department has defined the term "non-resident alien corporation" with respect to certain requirements of the law, to cover all corporations authorized or existing under the laws of a foreign country and having no office or place of business in the United States,

a non-resident alien is taxable under the law on interest received from a "resident alien corporation," that is, a foreign corporation having a branch office or place of business in this country has not been decided. If the interest is paid by the office in this country from funds earned here it may be taxable, but if paid from the home office in another jurisdiction it does not seem that it would be, even though paid out of funds arising in whole or in part from sources within this country, since this country would have no jurisdiction over the parties or the income. Interest paid by non-residents—whether citizens or aliens, corporations or partnerships, or by foreign governments,—is not taxable by reason of the fact that the interest may be paid in this country. The residence of the debtor, not the place of payment of the interest, determines its taxability. When interest on the bonds of foreign corporations or governments is payable in this country, the non-resident alien may prevent withholding at the source by filing with the paying agent a certificate prescribed by the Treasury Department for that purpose.[17]

INTEREST ON BANK DEPOSITS. Where banking houses in this country, carrying deposits for non-resident aliens, credit such accounts with interest thereon, such interest must be included in the recipient's income tax return for the year during which he received the interest, or in which it was credited to an account against which

T. D. 2401, but has made no definition with respect to residence of domestic corporations.

17 T. D. 2325. The official title of this form is Form 1071. It was drafted originally for the use of banks acting as agents, but may be modified to show personal ownership and, thus modified, may be executed by the non-resident alien himself. Letter from Treasury Department dated June 13, 1916; I. T. S. 1917, ¶ 122.

he might draw. The bank, however, is not required to withhold the tax on such interest or to make any return covering the amount of interest paid to any depositor.[18]

SALARIES PAID BY RESIDENT EMPLOYERS. Under the 1913 Law it was held that compensation paid to non-resident aliens for services rendered in a foreign country, including business and travel expenses, was not taxable.[19] The 1916 Law, by imposing a tax on "income from all sources within the United States," raises a question as to the taxability of such compensation, a question which is still before the Treasury Department for decision.[20]

INCOME RECEIVED FROM TRUSTEES, EXECUTORS OR OTHER FIDUCIARIES. Where a non-resident alien is the beneficiary of a trust, or of the estate of a deceased person, or is the recipient of income from any property held by another, such income is taxable to the extent that it arises from sources within the United States. The intervention of an agent, trustee or other fiduciary between the non-resident alien and the source of the income does not make income subject to taxation, which

18 Letter from Treasury Department dated June 29, 1917; I. T. S. 1917, ¶ 2256.

19 T. D. 2152.

20 The Treasury Department has indicated an intention to hold the non-resident alien, to be not taxable if the employer derives all his income from the foreign jurisdiction, but to hold him taxable if the major or principal part of the business is carried on in this country and the non-resident alien is employed in foreign jurisdictions as incident to the main business in this country. This distinction is artificial and will lead to many difficulties. A fair rule would seem to be to hold that the source of the income of non-resident alien employees is in the country where the services are performed even though payment is made from this country.

otherwise would not be taxable, nor does it serve to relieve from taxation income which otherwise would be taxed.[21] Dividends, for instance, would not be subject to the normal tax for the reason that they are paid to a trustee and by him distributed to non-resident aliens.[22] Similarly, exempt income is not made taxable by passing through the hands of a fiduciary to the beneficiary.[23] One important class of exempt income from estates is gifts, legacies, bequests, etc., the principal sum being exempt, but the income therefrom being taxable.[24] Where a non-resident alien is a trustee, or other fiduciary, of an estate deriving income from sources within the United States, he is charged with the duty of making a return of such income, and the normal tax is withheld at the source on payments of fixed and determinable income made to him by persons in this country.[25]

INCOME FROM PARTNERSHIPS. Non-resident aliens, who are members of partnerships deriving all their income from sources within this country, are taxable on their entire distributive shares.[26] If a partnership derives only part of its income from sources within the United States, non-resident alien partners are taxable only on that part of their respective shares of the profits which

21 Letter from Treasury Department dated March 25, 1915; I. T. S. 1917; ¶¶ 89 and 90.

22 Letter from Treasury Department dated April 5, 1916; I. T. S. 1917, ¶ 42.

23 Exempt income is not reported by the fiduciary, as income accruing to the estate, for the purpose of the tax.

24 See Chapter 25.

25 Letter from Treasury Department dated December 28, 1916; I. T. S. 1917, ¶ 1963. See Chapter 9.

26 See Chapter 10 on partnerships.

represent income of the partnership from such sources.[27] This would seem to be true although the partnership had its principal place of business here from which the operations abroad were directed.

PROFITS ON THE SALE OF PROPERTY. Non-resident aliens are taxable on profits and gains from the sale of real or personal property located in the United States.[28] Where sales of intangible personal property, for example, stocks, bonds, notes, etc., of domestic corporations or residents are made in the United States, the profit is held to be taxable and the custodian of the securities here is charged with the duty of reporting the profit of the non-resident alien, for which purpose he must place himself in possession of all the facts necessary to an accurate determination of the amount of profit or loss in the transaction.[29] If a sale of such intangible personal property is made in a foreign country by a non-resident alien, it does not seem that the seller would be taxable on the gain or profit therefrom.

OTHER INCOME. Gains or profits and income derived from any source whatever in the United States (except exempt income) are taxable.[30] The questions which arise

27 This is one of the many questions on which the Treasury Department has not as yet made any public statement of its position. The status of a partner differs from that of a stockholder in a corporation since in the case of a partnership there is no separate entity interposed between the recipient of the income and its original source.

28 See Chapter 20 for method of computing taxable gains on the sale of property.

29 Letter from Treasury Department dated May 31, 1916; I. T. S. 1917, ¶ 86.

30 Act of September 8, 1916, § 1, § 2 and § 4.

in this connection are with respect to the source of the income, rather than with respect to its character. Many of the questions will be settled only by the slow and gradual process of development of the law, through litigation and by specific rulings of the Treasury Department on cases brought to its attention.[31]

Deductions Allowed in Computing Net Income. A non-resident alien is required to report all his taxable income from sources within this country, but from the gross amount so reported is entitled to make certain deductions before the tax is assessed on the remainder. The deductions are similar in kind to those allowed to residents and citizens but, in general, are confined to expenditures made with respect to the income subject to tax or limited by the proportion of the individual's income derived from sources within this country. An extended discussion on deductions is contained in other chapters, the discussion in this chapter being limited to the provisions which apply particularly to non-resident aliens.[32]

EXPENSES. All necessary expenses actually paid in carrying on any business or trade conducted within the United States may be deducted, but not including per-

31 This development of the law may be hastened by action of Congress in making amendments more clearly defining taxable sources. At present there is not only uncertainty as to the meaning of the law as it stands, but also a need for amendment. The phrase "sources within the United States" is too broad and indefinite for practical certainty and it naturally results in imposing the tax on incomes in cases where there is serious question as to the moral right or economic wisdom of so doing.

32 The deductions allowed to a non-resident alien are set forth at length in the 1916 Law, § 6.

sonal living or family expenses. Where the business or trade carried on in this country is by means of separate and distinct branches the expenses are readily determined. Where the accounts are kept at, and the business is under the supervision of, the home office abroad, the home office expenses connected therewith, if segregated, may be included. If not segregated, the Treasury Department has permitted the deduction of such proportion of the entire expenses of the business as the gross income from this country bears to the entire gross income from business done both within and without the United States.[33]

INTEREST. The proportion of all interest paid within the year by a non-resident alien on his indebtedness, (except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under the 1916 Law) which the gross amount of his income for the year derived from sources within the United States bears to the gross amount of his income for the year derived from all sources within and without the United States may be deducted. For instance, if half of the individual's gross income for the year is from sources within the United States, he may deduct one-half of the entire amount of interest he has paid during the year on his indebtedness. To obtain this deduction it is required that the claimant report the entire amount of interest paid during the year and his entire gross income from all sources, so that the Treasury Department may calculate the amount of deduction to which he is entitled.[34]

33 See Chapter 28 for general discussion of deduction of business expenses.

34 See Chapter 29 on deduction of interest.

TAXES. Subject to the limitations applicable to all classes of taxpayers, the non-resident alien may deduct all taxes imposed by the authority of the United States or its territories, or possessions, or under the authority of any State, county, city, school district, and other taxing subdivision of any State, and paid within the United States. The general limitations are discussed in a subsequent chapter.[35]

LOSSES INCURRED IN TRADE. Losses incurred in the non-resident alien's business or trade may be deducted, if actually sustained during the year and incurred in business or trade conducted within the United States. Losses of property within the United States arising from fires, storms, shipwreck or other casualty, and from theft, may also be deducted to the extent that such losses are not compensated for by insurance or otherwise.[36]

LOSS NOT INCURRED IN TRADE. In the case of losses in transactions entered into for profit but not connected with his business or trade, the losses actually sustained during the year may be deducted to an amount not exceeding the profits arising therefrom in the United States. The profits arising from such transactions must be reported as income, and the losses sustained therein may be deducted, to an amount not exceeding the income so reported. It seems that the tax is imposed on the net profits of the year on a series of such transactions taking place in this country, the loss in one transaction being set off against the gain in another. But if the entire series of transactions results in a loss, that loss may not be set off against income from busines or trade in this

35 See Chapter 30 on deduction of taxes.

36 See Chapter 31 for general discussion of losses.

country. What constitutes losses not incurred in trade is explained in another chapter.[37]

Bad Debts. Debts, arising in the course of business or trade conducted by him within the United States, due to the taxpayer, actually ascertained to be worthless and charged off within the year, may be deducted.[38]

Depreciation. A reasonable allowance for the exhaustion, wear and tear of property within the United States, arising out of its use or employment, is granted under the same rules and regulations as apply to residents.[39]

Depletion of Natural Resources. A reasonable allowance is permitted for the depletion of oil and mineral deposits, if the property is within the United States. This depletion allowance is granted under certain rules and restrictions more fully discussed in the chapters dealing with that subject.[40]

Dividends. Taxable dividends received from this country must be reported. They are excluded from the net income for the purpose of computing the normal tax, but included for the purpose of computing the supertaxes.

Tax Withheld at the Source. As the law requires the normal tax to be withheld by the one in this country

37 See Chapter 4 for definition of losses not incurred in trade.

38 See Chapter 31 for general discussion of deduction of bad debts.

39 See Chapter 32 on depreciation.

40 See Chapter 33 and Chapter 34 on depletion.

who pays fixed or determinable income to a non-resident alien,[41] a due credit for the amount so withheld is allowed to be claimed in filing the annual return. The non-resident alien should therefore keep a record of the amount of tax withheld at the source from time to time on payments made to him, and should report the aggregate sum so withheld in his annual return, in order that the normal tax may not be twice collected with respect to the same income.

PERSONAL EXEMPTION. Under the 1916 Law, non-resident aliens were entitled to claim the same amount of personal exemption as residents or citizens, provided they filed the annual return, but by the amendment of October, 1917, this privilege was revoked.[42] The tax is now assessed upon all of the non-resident alien's net income from sources within this country.

Return of Annual Net Income. A non-resident alien, either personally or through his agents in this country, is required to file a return of annual net income on or before March 1 in each year, if his net income from sources within the United States is $1,000 or over during the year.[43] He may file the return, although his net

41 See Chapter 41 on collection at the source.

42 The privilege did not exist under the 1913 Law, as construed by the Treasury Department, so permission to claim the personal exemption was extended to non-resident aliens only in the year 1916.

43 The law is obscure on this point. The 1916 Law, § 8 (b), requires a return by every person having a net income of $3,000 or over for the taxable year; the 1917 Law, § 3, requires a return from unmarried persons if the net income is $1,000 or over, and from married persons if the net income is $2,000 or over. These amounts are predicated on the personal exemption allowed to unmarried and married persons, respectively, an exemption to which

income is less than $1,000, if he desires to claim the deductions and credits allowed him under the law.[44] Thus, a non-resident alien may have had the tax on all his income from this country withheld at the source, although he may be taxable on a lesser amount by reason of deductions for expenses, interest, losses, etc. Only by filing a return may he claim those deductions, and upon so doing, the amount withheld, in excess of his tax liability, will be returned to him. For the purpose of obtaining such refund, he should attach to his return a statement giving the names and post-office addresses of all persons, firms or corporations who have withheld the tax on income paid to him during the year, and the amount of tax withheld by each respectively. The Treasury Department will thereupon order the withholding agents to release the excess withheld.[45] Non-resident aliens are entitled to extensions of time for filing returns, and are subject to penalties for failure to file returns, under the same provisions of law as apply to citizens.[46] In case a non-resident alien fails to file a return, the

non-resident aliens are not entitled. However, it seems clear that the law does not require a return of individuals in any case where the income for the year is less than $1,000, and it would seem that Congress did not intend to allow a married non-resident alien any greater exemption because of his married status.

44 The same form (Form 1040) is prescribed for use of all individuals, residents and non-residents. A non-resident alien preparing the return on this form should bear in mind that it covers in his case only income from sources in this country, and make such changes as are necessary to indicate that fact. The additional information required in order to compute the amount of deductible interest should be made on a supplementary statement attached to the return.

45 Telegram from Treasury Department dated January 25, 1917; I. T. S. 1917, ¶ 1997.

46 See Chapter 35 and Chapter 37.

collector may assess the tax on information from other sources, and all property of such alien in this country will be liable to distraint for the tax.[47] The return is filed in the district in which the non-resident alien has his principal place of business in this country, or if he has none, then with the Collector of Internal Revenue at Baltimore, Maryland. If the return is filed by an agent in this country, the place of filing may be either the district in which the agent resides or the district in which he has his principal place of business. It should be borne in mind that a non-resident alien may have an agent in this country, for the purpose of the income tax, without having appointed one. The fact that $1,000 or more of income of a non-resident alien is in the custody or control of a resident of this country, makes that resident an agent, charged with the duty of making an annual return and collecting the tax. A non-resident alien may, therefore, have several agents in this country, each responsible for the income passing through his hands. To avoid having a return filed by each, the non-resident alien may make one return covering all of his income, or designate one of the agents to make such return, in which case he must inform the agent so designated of all his taxable income from sources within this country. The other agents should also be notified of the action taken and instructed not to file returns. The duties and responsibilities of such agents are more fully discussed in a subsequent chapter.[48]

Paying the Tax. The tax is due on June 15 following the filing of the annual return, and penalties accrue if

[47] Act of September 8, 1916, § 6 (c), as amended by Act of October 3, 1917.

[48] See Chapter 6 on Resident Agents.

it is not paid within ten days after notice and demand therefor.[49] If the return is not filed on time, the tax is due immediately upon assessment, and penalties accrue if not paid within ten days after notice and demand. Penalty and interest for delay in payment are added, as in the case of delinquent residents or citizens.[50] As to the form in which to make payment see the chapter on assessment and payment of the tax.[51]

Abatement and Refund of the Tax. If upon the filing of the annual return, it appears that the non-resident alien is liable for less tax than the amount which has been withheld at the source, the Treasury Department will issue instructions to the withholding agents (whose names and addresses should be given by the non-resident alien on his return) to release at once the proper amounts.[52] After the tax has been assessed against the withholding agents by the Government, abatement may be claimed, and after the tax has been paid, refund may be claimed, in the manner outlined in a later chapter.[53]

49 See Chapter 36.

50 Id.

51 Id.

52 Telegram from Treasury Department dated January 25, 1917; I. T. S. 1917, ¶ 1997.

53 See Chapter 39 on Abatement and Refund.

CHAPTER 6

RESIDENT AGENTS FOR NON-RESIDENT ALIENS, FOREIGN CORPORATIONS AND FOREIGN PARTNERSHIPS

As set forth in another chapter[1] the law expressly provides for the collection at the source of the tax on payment of certain specified forms of income to non-resident aliens and non-resident foreign corporations. The persons required to withhold and account for the tax are designated in the regulations as withholding agents. The Treasury Department has, in addition, evolved a method of collecting the tax on income which may pass out of its jurisdiction, by impressing upon residents, under certain circumstances, the duty of filing returns and accounting for the normal tax and the super-tax on any and all income of non-resident aliens and non-resident foreign corporations over which they have custody or control.[2] Such persons are held to be agents of the non-residents and to stand in the place of their principals.[3] One who is a withholding agent under the provisions for collecting the tax at the source may, or may not, (depending on the circumstances) also be an agent within the meaning of this chapter. Agents for foreign

1 See Chapter 41 on collection at the source.

2 The Department evidently bases its authority for this on § 9 (g), of the 1916 Law which provides that the tax shall be paid by the owner of the income "or the proper representative having the receipt, custody, control or disposal of the same." T. D. 2452.

3 T. D. 2135.

partnerships are not required to make any returns or pay any tax for the foreign partnership unless and until they are so instructed by the Commissioner of Internal Revenue.[4]

Definition. In order to simplify the discussion in the following pages of this chapter the term "non-residents" will be used to include non-resident aliens, foreign corporations having no office or place of business in this country, and foreign partnerships having no office or place of business in this country.[5]

Who are Resident Agents. A resident corporation, partnership or individual, may be an agent within the meaning of this chapter. Any residents acting by power of attorney for non-residents are such agents. Responsible heads or representatives who are in charge of property owned or business carried on by non-residents in this country are such agents.[6] Resident nominal stockholders who hold stock in their names for non-resident actual owners are such agents.[7] Residents having custody of securities of non-residents, on which they collect the income, are agents not only with respect to the income, but also with respect to any profits made from the sale of the securities of which they are custodians, and for the purpose of reporting the latter they are required to obtain all facts necessary to ascertain

4 T. D. 2401. This is because a partnership is not itself subject to a tax or required to make returns. See Chapter 11 on foreign partnerships.

5 For definition of "foreign corporations" as used in this book see Chapter 14. For definition of foreign partnership as used in this book see Chapter 11.

6 Reg. 33, Art. 8; T. D. 2313.

7 See Chapter 7 on nominal stockholders.

the profit in any transaction.[8] Residents, purchasing patent rights from non-residents and paying royalty thereon, are held to be agents.[9] Real-estate agents who manage buildings owned by non-residents are such agents.[10]

Who are Not Such Agents. Corporations paying interest on their own bonds, or dividends on their own stock, to non-residents, bondholders or stockholders, are not held to be agents within the meaning of this chapter, although they are withholding agents for the purpose of collection at the source. Resident debtors, individual or partnership, are not held to be agents, but are required to withhold to tax at the source on interest paid to non-resident aliens. Banks are not agents for théir non-resident depositors, where the relation is merely that of bank and depositor[11] and the same has been held where a bank received interest and dividends direct from domestic corporations to be credited to the accounts of non-resident depositors.[12] A bank holding, for account of foreign banks and bankers, securities on which it collects interest and disburses the same to the foreign banks and bankers, has not been held to be an agent,[13] but where a bank acts as custodian of securities for non-

8 Letter from Treasury Department dated May 31, 1916; I. T. S. 1917, ¶ 86.

9 T. D. 2137.

10 Letter from Treasury Department dated January 19, 1915; I. T. S. 1917, ¶ 80.

11 Banks are not held to be withholding agents with respect to interest paid on deposits. Reg. 33, Art. 67.

12 Letter from Treasury Department dated February 8, 1917; I. T. S. 1917, ¶ 2003.

13 Letter from Treasury Department dated April 10, 1916; I. T. S. 1917, ¶ 120.

residents other than banks, the rule seems to be that it is an agent.[14]

Duties and Liabilities of Resident Agents. The duty of a resident agent for a non-resident alien individual or non-resident foreign corporation is to account for all income passing through his hands, in an annual return to the local collector, and to pay all taxes assessed thereon.[14a] He is under no duty to inquire into or report any income of the non-resident principal received from other sources in this country, but may, if authorized by the non-resident principal, make a complete return of all income from this country. Where the same non-resident has several agents, none of whom is authorized and enabled to make a return of all the principal's income, each agent reports separately the income coming into his hands, and the Treasury Department takes into consideration the aggregate amount of net income, covered by all of the returns, in assessing the tax, giving credit for the amount assessed on each return, and making a further assessment to cover the supertax which may be due on the aggregate income in the case of individuals.[15] Of course, if the non-resident principal files a return of all his income from sources within this country, the agents are not also required to file returns. Resident agents should, therefore, ascertain in due time

14 The rulings are not clear or consistent on this point, but it seems that the rulings bear out the conclusions in the text.

14a It is uncertain under the language of the 1917 Law whether or not a resident agent can be required to file a return for a non-resident principal if the amount of income in his custody is less than $1,000 during any year. A ruling on this point will be necessary.

15 Letter from Treasury Department dated March 6, 1917; I. T. S. 1917, ¶ 2112.

what their non-resident principals intend to do as to reporting and paying the tax, and govern themselves accordingly.

Procedure in Collecting Income for Non-Residents. In collecting income subject to withholding of the tax at the source, the resident agent should execute the ownership certificate required of his non-resident principal, signing it with the name of the principal and affixing his own signature as agent.[16] In brief, with respect to such income, he should proceed as is required of the non-resident principal, in whose place he stands for the purpose of the income tax. The fact that the non-resident has an agent here does not relieve his income from withholding at the source when paid to such agent.

Making Returns for Non-Resident Principal. In making the annual return for his non-resident principal the resident agent should use the same form as would be used by the principal[17] and follow the provisions of the law and the regulations relating to non-resident aliens or foreign corporations, as the case may be, in claiming deductions. At present the same forms are used for residents and non-residents alike, and, when used by or for a non-resident alien, require certain changes in wording, such as a statement at the beginning that the return covers only income from sources within the United States. In the affidavit at the end of the individual's form, to be executed by the agent, a statement should be made that the return covers only the

16 See Chapter 41 on collection at the source.

17 Form 1040, in the case of individuals; Form 1030 or 1030A, in the case of insurance companies, and Form 1031, in the case of other corporations.

income received by the agent, or that it covers all of the income of the principal from sources within the United States, as the case may be. The affidavit on the corporation's form is prepared for execution by two officers of the corporation. When the return is signed by an agent for a foreign corporation, an affidavit that he is the properly authorized agent, and that the report covers income from all sources within the United States, or income passing through his hands, as the case may be, should be attached to the return and duly executed. The return may be filed in the district in which the agent resides or has his principal place of business.

Paying the Tax for Non-Resident Principal. After filing the return, the agent will in due course receive a notice of assessment showing the amount of tax assessed on the income reported.[18] The tax becomes due and payable at the same time and in the same manner as the tax assessed on the income of a resident, and may be paid in the same way.[19] Upon paying the tax, the agent may demand a separate receipt for the amount paid on behalf of his non-resident principal, and such receipt is sufficient evidence to justify the agent in withholding the amount therein expressed from his next payment to the principal, if he has not already withheld a sufficient

[18] A special ruling was made to cover cases in 1916, where the agent for a non-resident alien had received income from corporate interest or dividends and paid the same over to his principal prior to September 8. In such cases, if the agent did not have, between September 8 and the end of the year, any income of the non-resident alien from which to pay the tax he was relieved from liability, leaving the tax a charge against the non-resident alien to be collected direct from him by the Treasury Department. T. D. 2402.

[19] See Chapter 36 on assessment and payment of the tax.

amount to satisfy the tax. The principal may demand this receipt from the agent upon giving him a full written receipt acknowledging the payment of the tax as a satisfaction of the agent's debt to that extent.[20]

Abatement and Refund. Taxes improperly or illegally assessed or collected may be abated or refunded in the manner indicated in the chapter dealing with that subject.[21]

20 Act of September 8, 1916, § 17.

21 See Chapter 39 on refund and abatement.

CHAPTER 7

NOMINAL STOCKHOLDERS

For convenience in handling financial transactions, stock certificates are sometimes issued in the names of persons other than the actual owners of the stock. The persons so holding the nominal title to the stock are known as nominal stockholders, or stockholders of record, and, of course, are agents for the actual owners within the meaning used in the preceding chapter, when the actual owners are non-resident aliens or non-resident foreign corporations. Nominal stockholders, acting by arrangement between the parties, are, of course, aware of the name and status of the actual owner, but in some cases one may become a nominal stockholder without any knowledge of who the actual owner is. Thus, stock certificates, endorsed in blank by an actual owner and sold on the market, may pass by delivery to several consecutive purchasers before the stock is transferred on the books of the corporation. In such cases, the original transferor remains the record owner until the transfer is made on the corporate books, and, as such, is presumed to be the real owner of the dividends declared on the stock, unless he proves that actual ownership of the stock does not rest in him. If, however, the record owner has not only parted with his certificate endorsed in blank, but has also given the corporation a "dividend order" to pay the dividends to another, his responsibility for the tax on such dividends ceases, and the one to whom

the corporation pays the dividends becomes liable for any tax thereon, unless he in turn shows that actual ownership does not rest in him. Where the stockholder of record continues to receive the dividends and subsequently pays them over to the one claiming to be the actual owner, or agent for the actual owner, he should ascertain the name and address of the one to whom the payment is made, and, if such payee is not a non-resident alien or a non-resident foreign corporation, the nominal stockholder is under no further duty than, perhaps, to report the name and address of the payee under the provisions of law requiring information at the source. Thus, if a nominal stockholder pays over the dividend to a resident, even though he knows such resident to be the agent of a non-resident alien, he is under no duty as agent, since it is the one who collects the dividend for a non-resident or who finally pays it over to a non-resident, who has impressed upon him the duty of agent within the meaning of the preceding chapter.

Procedure When Actual Owner Is a Resident or Citizen. The Treasury Department has as yet issued no regulation requiring the nominal or record owner of stock to disclose the names of actual owners who are residents or citizens.[1] The primary purpose of requiring disclosure of the actual owner is to assist in administering that provision of the 1916 Law which makes dividends on domestic stocks taxable when paid to non-resident aliens and requires withholding when paid to non-resident foreign corporations.[2] The actual owner is, of

[1] The rulings on this subject have not always been consistent but it seems that the statements contained in this chapter represent the present attitude of the Treasury Department.

[2] Letter from Treasury Department dated November 21, 1916; I. T. S. 1917, ¶ 183.

course, in all cases under the duty of reporting the dividends and paying tax thereon, if he is liable; the nominal stockholder is under no duty to report the dividends as his income, but should be prepared, if question arises, to show that the actual ownership does not rest in him.

Procedure When Actual Owner Is Non-Resident. Where the nominal stockholder is a resident of this country and is acting for, or paying the dividends to an actual owner who is a non-resident alien individual, or a foreign corporation or partnership having no office or place of business in this country, a certificate [3] should be obtained by the nominal owner from the actual owner, disclosing the facts of such ownership, which certificate is required to be forwarded by the nominal owner to the collector of internal revenue in the manner stated below. A certificate of actual ownership once filed is held to be sufficient until ownership changes, when it is necessary to disclose the new actual owner, as in the first instance. In such cases, the nominal stockholder is deemed to be an agent in this country for the non-resident actual owner and will be required to make a return of net income and to pay any tax due on the dividends which pass through his hands, just as other agents for non-resident aliens are required to do under the law.[4] The certificates disclosing actual ownership should be attached in such cases to the return of income filed for the actual owner. If the amount of income is so small that no annual return is required, the certificates disclosing actual own-

[3] This certificate is officially known as Form 1087.

[4] See Chapter 6 for duties of agent as to making returns and paying tax for non-resident aliens and non-resident foreign corporations.

ership should nevertheless be filed with the local collector as proof of the fact that the nominal stockholder is not the actual owner of the stock. If the actual owner is a non-resident alien partnership, the nominal owner is required to make no return and account for no tax unless and until he is so instructed by the Commissioner of Internal Revenue; certificates disclosing the actual ownership should, however, be obtained by the nominal stockholder and transmitted to the local collector.[5]

Procedure When the Nominal Stockholder Is a Non-Resident Alien. When the record owner of stock of domestic or resident corporations is a non-resident alien individual or partnership, he or it should disclose the actual owner, or the tax will be assessed on the basis of apparent ownership. When the actual ownership is disclosed, the Commissioner of Internal Revenue will make such assessments and issue such instructions to the paying corporations in this country as will insure the proper collection of the tax in accordance with actual tax liabilities. The certificates disclosing ownership should be filed by non-resident alien individuals and partnerships with the Collector of Internal Revenue at Baltimore, Maryland, being attached to the return of annual net income of the nominal stockholder, if such a return is filed. In case the non-resident nominal stockholder is a corporation or organization against which the tax will be withheld at the source on payments of dividends, the certificate disclosing actual ownership may be filed with the corporation paying the dividend or its paying agent in the United States,[6] and upon the filing thereof, the

[5] T. D. 2401.

[6] T. D. 2452. The form to be used is Form 1037 striking out the words "to be filed with representative in the United States

paying corporation will not withhold the tax upon such amounts as are shown by the certificates disclosing actual ownership to be owned by others than non-resident foreign corporations or organizations subject to withholding. If the certificates disclosing actual ownership indicate that the actual owner is a non-resident foreign corporation, the corporation paying the dividend will deduct the tax on the amounts of dividends paid to the nominal stockholder for the account of such non-resident foreign corporation.[7] There is no duty on the part of a non-resident nominal stockholder to file any return or account for any tax on behalf of the actual owner. That duty is imposed only when the nominal stockholder is a resident of this country.[8] A foreign partnership, although not itself subject to tax, should file certificates disclosing the actual ownership of stock standing in its name, in order to release its individual members from the tax liability which would otherwise attach on their distributive shares of the partnership profits by reason of the apparent ownership.

Dutch Administration Offices. A special ruling has been made with respect to the so-called "Administra-

of such foreign principal" in the caption and the words "in the United States" in the body of the form, and executing the certificate as the representative of the actual owner in the space provided for signature.

7 Letters from Treasury Department dated October 6, 1917, and October 23, 1917; I. T. S. 1917, ¶¶ 2466 and 2467.

8 T. D. 2452 seems to impose such a duty on non-residents, but a subsequent letter from the Treasury Department dated April 7, 1917 (I. T. S. 1917, ¶ 2187), states that the requirements set forth in that T. D. to the effect that the nominal owner will be required to render annual returns for and in behalf of the actual owner applies only to such nominal owners as are residents of the United States.

tion Offices'' in Holland, which has application to many similar situations in foreign countries. It appears that the Dutch Administration Offices are the registered owners of large blocks of American stocks, against which they have issued bearer certificates, with coupons attached. These coupons on presentation and surrender entitle the bearer to dividends declared on the stock. The Administration Offices are held to be agents for the holders of the bearer certificates and are *prima facie* liable for the tax on all dividends paid on the stock standing in their names, unless they disclose the names of the actual owners by use of the proper certificates.[9] They are required to make returns of income and pay the tax on all dividends received, except such amounts as are shown by certificates disclosing actual ownership to have been received for the account of non-resident alien individuals. Such certificates should be attached to the return when filed.[10]

Bearer Certificates. When stock of an American corporation is floated in some European countries, where investors are accustomed to bearer stock certificates, a block of the stock is sometimes issued to a trust company in this country which in turn issues bearer certificates entitling the holder to certificates of stock for the number of shares designated, upon the surrender of the bearer certificate, and to any dividends which may

[9] Form 1087.

[10] T. D. 2386. The Treasury Department also provided in this treasury decision for the appointment of an agent in this country by such Administration Offices, upon doing which the tax will not be withheld at the source. It seems, also, that by filing certificates disclosing actual ownership with the paying corporation withholding at the source may be avoided to the extent indicated in T. D. 2452.

be declared on such shares while the bearer certificate is outstanding. The bearer certificates pass by delivery, the dividends being claimed through foreign banks by presentation and surrender of numbered coupons attached thereto. In such cases the trust company is in the position of a resident nominal stockholder and to avoid liability for the tax on dividends received by it on such stock, should obtain and file certificates disclosing actual ownership and proceed in other respects as indicated above.

CHAPTER 8

FIDUCIARIES

The law provides that "Guardians, trustees, executors, administrators, receivers, conservators, and all persons, corporations, or associations, acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals."[1] For the purpose of discussion in this book fiduciaries are divided into two classes, this chapter dealing with the subject in general and with the particular provisions applicable to domestic fiduciaries, that is, those which reside in this country or have an office or place of business here and consequently are within the jurisdiction of this Government. Foreign fiduciaries, which subject is treated in the following chapter, are defined for the purpose of this book as fiduciaries who neither reside in this country nor have an office or place of business here, that is, those who are not within the jurisdiction of this Government. A non-resident citizen acting as a fiduciary would, it seems, be entitled to be classed with the domestic fiduciaries since the United States has some measure of jurisdiction over him as a citizen, and since the withholding provisions of the law do not apply to non-resident citizens.

1 Act of September 8, 1916, § 8 (c).

Who Are Fiduciaries. It will be noted by the provision of the law quoted in the preceding paragraph that an individual, a corporation or an association may be a fiduciary under the law. A fiduciary for income tax purposes is one who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest,[2] or receives and controls the income of another as in the case of receivers.

AGENTS. An agent, as such, is not a fiduciary for his principal even though he may have complete charge of the property of his principal.[3] There may be a fiduciary relationship between an agent and a principal but the word "agent" does not denote a fiduciary within the meaning of the law.[4]

POWER OF ATTORNEY. A person cannot, by power of attorney, appoint another to act as a fiduciary. A person acting under a power of attorney in the management of property, having no title thereto, but with full authority to deal with the property as he sees fit, is merely an agent. A power of attorney does not constitute a fiduciary relationship, and, in all cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability under the law to make returns and pay the tax rests with the principal.[5]

GUARDIANS. A legal guardian is a fiduciary but it does not seem that a natural guardian comes within the definition. It has been held by the Treasury Depart-

2 T. D. 2090.
3 T. D. 2135.
4 T. D. 2090.
5 T. D. 2137.

ment that where a minor child is in receipt of income, the father, his natural guardian, cannot make a return covering the income of the child but should include the income of the minor as a part of his (the father's) income for the year.[6] The income of a minor child can be reported separately only when a separate legal estate has been created.

TRUSTEES. Trustees are expressly specified in the law as fiduciaries. They are required to report the income of the trust and the distributive interests therein of the beneficiaries. If a part of the income of the trust for any year is not distributed or distributable the income tax, both normal and supertax, on that part, as an entity, must be reported by the trustee and the tax paid by him.

EXECUTORS AND ADMINISTRATORS. Executors and administrators are fiduciaries with respect to the estate of the deceased person under their control. They are subject to certain special duties with respect to reporting income of the deceased and reporting and paying the tax upon the entire income of the estate during the period of administration or settlement, as more fully indicated in the following paragraphs.

RECEIVERS. A receiver for an individual is a fiduciary but a receiver for a corporation is not.[7] It is especially provided that receivers, trustees in bankruptcy,

[6] Letter from Treasury Department dated October 30 1916, I. T. S. 1917, ¶ 248. To hold otherwise would, of course, give endless opportunity for evasion of the law.

[7] Letters from Treasury Department dated February 27, 1915, and June 22, 1916; I. T. S. 1917, ¶¶ 597 and 598.

or assignees operating the property or business of a corporation shall make returns of the income in the same manner and form as is required of corporations, and the tax will be assessed and collected in the same manner as if assessed directly against the corporation of whose business or properties they have custody and control.[8]

TEMPORARY RECEIVER HELD TO BE FIDUCIARY. One appointed under interlocutory orders of the United States District Court to act as receiver of an individual in a proceeding wherein certain persons complaining as creditors were seeking to have the property of the individual distributed among them, was held to be a fiduciary, notwithstanding that title to the property in question (cash and securities) remained in the individual sued and that his position and right to deal with the same was only suspended. The receiver having received income from the property in his possession was required to file a return as a fiduciary.[9] On the amount reported in the return as income, a tax would be paid as in the case of undistributed net income of estates.

COMMITTEE FOR AN INCOMPETENT. The committee for an incompetent person is regarded as a fiduciary.[10]

Who Are Beneficiaries. A beneficiary within the meaning of the law and the regulations, and in the sense used in this book, is the ward, *cestui que trust*,

8 Act of September 8, 1916, § 13 (c).

9 Letter from Treasury Department dated January 22, 1917.

10 Letter from Treasury Department dated February 21, 1916; I. T. S. 1917, ¶¶ 605 and 606.

legatee, distributee, creditor, or other person entitled to any part of the net income of a trust or estate in the charge of a fiduciary. The trust estate itself is called a beneficiary with respect to the undistributed income of the estate.

Duties of Fiduciaries Generally. Fiduciaries are required by the law to "make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals."[11] Where income has been received by an estate or from any kind of property held in trust, the tax is to be assessed against the fiduciary, unless (a) the income is returned for the purpose of the tax by the beneficiary or (b) the income is to be distributed annually or regularly between existing beneficiaries, in which case the rate of tax and method of computing the same is based upon the amount of the individual shares to be distributed. Fiduciaries are indemnified by the law against the claims or demands of every beneficiary for all payments of taxes which they shall be required to make under this provision of the law, and are given credit for the amount of such payments against the beneficiary or principal in any accounting which they may make as such fiduciaries.[12]

Duties of Executors and Administrators. In addition to the duties which executors and administrators have in common with other fiduciaries, they are also required under the law to report the income of the decedent for that part of the last year during which

[11] Act of September 8, 1916, § 8 (c).
[12] Act of September 8, 1916, § 2 (b).

he lived; and also for the preceding year if the decedent died before the time for filing returns for such year had expired and no return had been filed by him. Thus, if a decedent died in February, 1917, without having made a return for 1916, the executor or administrator is required to file a return for 1916 and a return for the part of 1917 in which the decedent lived. The income tax due from a deceased person is a debt against the estate in the hands of his executor or administrator and under the authority of the law[13] the Treasury Department requires the executor or administrator to file a return for the decedent covering the unreported income received by the decedent up to the time of death, in order that the amount due to the Government from the decedent's estate may be determined and paid.[14] If the net income of the decedent, from January 1 of the year in which he died to the date of his death, was less than the sum which would have made him liable to make a return if living, no return is required by the executor or administrator.[15] The personal exemption which may be deducted from the decedent's income so reported, under the 1916 Law and the 1917 Law respectively, is the full amount allowed to living persons of the same status as that of the decedent at the time of his death.[16]

Receiver. Where a receiver for an individual, acting under interlocutory orders of the court, receives income during any year on funds which he holds in trust as

13 Act of September 8, 1916, § 9 (g).

14 T. D. 2152.

15 Act of October 3, 1917, § 3; see also T. D. 2090 and Regs. 33, Art. 17.

16 See Chapter 4, paragraph on personal exemption.

such receiver, such income must be accounted for and the tax paid thereon for that year. The receiver is indemnified against the claims or demands of every beneficiary and shall have credit for the amount of such payments against the beneficiary or principal in any accounting which he makes as such receiver. The income being thus freed of tax liability imposed by statute, it assumes the status of capital and may thereafter be distributed by the receiver in the same manner as other capital. The fact that all or any part of the income received by a receiver may be used to pay creditors does not relieve the receiver from first paying the tax on all income received by him, less the deductions, credits and exemptions allowed by the law—the Government has a prior lien for the amount of the tax; what remains may be distributed to creditors or others.[17]

Trust Estates. In the following discussion of the subject of fiduciaries the term "trust estates" is used as meaning the estate or property over which the fiduciary has control, whether he be a guardian, trustee, executor, administrator, receiver, or otherwise.

Income of Trust Estates. The income of a trust estate embraces the income from all sources, as in the case of individuals, excluding exempt income. The chapters on the subject of income should be read in this connection. The corpus of the estate, that is, the amount of the capital transferred to the estate at the time of its creation, is not income. Thus, in the case of decedents' estates the appraised value of the property at the time of the death of the decedent

17 Letter from Treasury Department dated February 9, 1917; I. T. S. 1917, ¶ 2008.

is the capital of the estate, regardless of the fact that the cost of that property to the decedent may have been much less. All income derived from such property after the death of the decedent is income to the estate. Income derived by the decedent before his death is capital when received by the estate. The rules laid down by the courts with respect to the difference between income and capital in cases between life tenant and remainderman do not necessarily apply under the provisions of the income tax law, so far as assessing the tax is concerned. Thus, extraordinary dividends received by an estate are income to the same extent as if received by an individual, although a part of the fund from which such dividend is declared may have been earned by the corporation prior to the creation of the estate.

Deductions Allowed Trust Estates. A trust estate is allowed, in general terms, the same deductions as are allowed to individuals. The Treasury Department, however, has made several special rulings with respect to deductions which may be claimed by fiduciaries against the income of trust estates and these rulings are given in the following paragraphs.

BUSINESS EXPENSES. The usual and necessary expenses of carrying on a business which may be conducted by the fiduciary including salaries, wages, rentals, repairs to business properties, etc., are held to be properly deductible, since they are expenses which reduce the income accruing to the beneficiaries.[18]

EXPENSES NOT DEDUCTIBLE. A distinction is made between such expenses as are properly chargeable against

[18] T. D. 2135.

the corpus of an estate at the time of its creation, and such other expenses incident to administration, as may arise from the nature of the properties and the details of business management. Thus, court costs, attorneys' fees, executors' commissions, etc., are held generally to be expenses that reduce the corpus of the estate in the administrator's hands and not expenses which directly reduce the income accruing to the beneficiaries. Therefore such expenses are not a proper deduction from the annual income.[19]

EXECUTORS' COMMISSIONS. If under the laws of the state or the terms of the will or the decree of a court executors' commissions are deductible from the corpus of the estate they should not be included as deductions in the annual return of the fiduciary, but if they are to be deducted from the income of the estate distributable among the beneficiaries the amount should be entered as a legitimate and necessary expense.[20]

INTEREST. Any interest which a trust estate may be required to pay to creditors is a proper reduction, except interest or indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from the income tax.[20a]

TAXES. Any tax paid by a trust estate is a proper deduction to the same extent as in the case of individuals or corporations. Inheritance taxes are held not to be deductible.[21].

19 T. D. 2090; T. D. 2135.

20 Letter from Treasury Department dated March 2, 1915; I. T. S. 1917; ¶ 660.

20a See Chapter 29.

21 See Chapter 30 on deduction for taxes.

LOSSES. Losses actually sustained during the year, incurred in business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, not compensated for by insurance or otherwise may be deducted under the same rules as are applicable to individuals.[22] In case the estate was created prior to March 1, 1913, a loss sustained by the sale of property is determined by the fair market price or value of the property as of that date. If the estate was created subsequent to March 1, 1913, the loss is determined on the basis of the appraised value of the property at the time the decedent died or the estate was created.[23]

DEPRECIATION. The general rules relating to depreciation[24] are modified in the case of trust estates, by the following ruling of the Treasury Department: In the case of a trust estate where the terms of the will or trust, or the decree of a court of competent jurisdiction, provide for keeping the corpus of the estate intact, and where physical property, forming a part of the corpus of such estate, has suffered depreciation through its employment in business, a deduction will be permitted for depreciation, if the deduction is applied or held by the fiduciary for making good such depreciation. No depreciation deduction will be permitted to fiduciaries other than as here provided. Fiduciaries should set forth in connection with their returns the provision of the will or trust or decree requiring such depreciation deduction, where any exists, or that actual depreciation occurs, the amount thereof, and that the

22 See Chapter 31 on Deduction of losses.

23 Telegram from Treasury Department dated February 3, 1917; I. T. S. 1917, ¶ 1999.

24 See Chapter 32.

same has been or will be reserved and applied as such. The intent is to deny to fiduciaries the right of claiming a deduction for depreciation if the amount of such deduction is actually paid to the beneficiary as income. This ruling, however, does not deny the trustee the right of making deductions for expenses actually incurred for repairs and such other necessary expenses, other than betterments, as may be required to preserve the corpus of the estate.[25]

DEPLETION OF NATURAL RESOURCES. If an estate has capital invested in mines or oil or gas wells, depletion for the exhaustion of the natural deposits may be claimed to the same extent as is permitted to individual owners.[26]

Net Income of Trust Estates. The net income of a trust estate consists of the amount of the total taxable income from all sources less the amount of the deduction permitted by law. From this net income may be deducted, for the purpose of assessing the normal tax, the amount of dividends received by the estate (which amount has been included in the gross income) and income, if any, on which the normal tax has been or is to be paid at the source. The amount of net income remaining after these deductions is subject to the normal and the supertaxes in the hands of the respective beneficiaries, or in the hands of the estate with respect to that part which is not distributed among the beneficiaries. The amount of net income represented by dividends, and income on which the normal tax has been paid or is to be paid at the source, is subject to

25 T. D. 2267.
26 See Chapters 33 and 34.

the supertax in the hands of the beneficiaries or in the hands of the estate, as the case may be.

Distribution of Income of Trust Estates. When any part of the net income of a trust estate for any year is distributed to beneficiaries, the fiduciary is required to report the respective amounts paid or credited to each beneficiary. The beneficiaries are required to report such amounts in their personal returns and add the same to income from other sources in order to determine their respective tax liabilities. If a beneficiary is a non-resident alien the normal tax must be withheld at the source and the fiduciary will also be required to account for the supertax, and to make returns for the non-resident alien beneficiary in the same manner as other resident agents for non-resident aliens are required to do.[27] If the beneficiary is a minor, or is incompetent, the fiduciary will be required to make the return for him and to pay the tax for him as his agent.

INCOME NOT ACTUALLY PAID TO BENEFICIARIES IN YEAR. Fiduciaries having control of income accruing during the year to a known beneficiary, whether or not actually distributed or paid to the beneficiary during the year, are required to report the name of the beneficiary to whom such distributive interest accrues, and in all such cases the tax is assessed to the beneficiary on the basis of his taxable status. Where the tax on such annual income has been paid, it is not again payable when later that income is actually turned over to

[27] See Chapter 6 for duties of resident agents for non-resident aliens.

the beneficiary.[28] The theory seems to be that such income is separated from the estate when it is credited to the beneficiary, the fiduciary thereafter holding it, not as fiduciary, but as agent for the beneficiary.

Distribution of Income of Several Years. Where a decedent died in 1913, leaving a will devising a part of his estate in trust to pay the income therefrom to one beneficiary during life, and other parts to be divided among other beneficiaries, and it was impracticable for the executors to complete distribution of the estate or determine the amount of net income until 1916, at which time an account was prepared showing the net income accruing to each beneficiary during the last three months of 1913 and during the years 1914 and 1915, a large part of the accumulated income being distributed in 1916, it was held that the executors should make a fiduciary return for each of the years 1913, 1914, 1915 and 1916, reciting therein the respective beneficiaries and their interests, and the beneficiaries could make amended returns for such of those years in which they would be taxable by reason of the amount so distributed.[29] In this case, apparently, the respective shares of the beneficiaries were known at all times, but the amount of net income of the estate was not determinable until 1916. Where the interests of the beneficiaries are not determinable, but the income is, the rules discussed in the following paragraphs apply.

Undistributed Income of Trust Estates. The 1913 Law was silent as to the taxability of undistributed

28 T. D. 2289, Reg. 33, Art. 75.

29 Letter from Treasury Department dated March 24, 1917; I. T. S. 1917; ¶ 2172.

income of trust estates. It was first held by the Treasury Department that if income was added to the corpus of the estate, under a provision of the will or under a statute, no tax would accrue with respect thereto, but later, under that Law, it was held that such income was taxable, as an estate could not be without a beneficiary for income tax purposes. Where the beneficiaries and their beneficial interests were known the income was to be reported as accruing to them and the estate itself was to be listed as a beneficiary as to any of its income not otherwise beneficially assigned or accounted for.[30] In the case of decedents' estates, however, it was still held that the executor of the estate was required to make no return for the estate until the settlement thereof had reached a stage where the beneficiaries and their respective interests in the income were determinable, at which time returns should be made showing the annual accrual, a separate return being required for each tax year involved.[31] These rulings, however, do not apply under the express provisions of the 1916 Law discussed in the following paragraphs.

INCOME RECEIVED DURING SETTLEMENT OF DECEDENT'S ESTATE. "Income received by estates of deceased persons, during the period of administration or settlement of the estate, shall be subject to the normal and additional tax," the tax to be assessed against the executor or administrator and paid by the estate, except when the income is returned for the purpose of the tax by the beneficiary. If the income is to be distributed

30 T. D. 2231.

31 Letter from Treasury Department dated March 4, 1916; I. T. S. 1917, ¶ 576. See also ¶ 575; T. D. 2289; T. D. 2231 and T. D. 1943.

annually or regularly among existing heirs or legatees, or beneficiaries, and the latter report their respective shares, the estate is not taxed, the rate of tax and method of computing the same being then based in each case upon the amount of the individual share to be distributed.[32] Thus, where a specific legacy is contained in a will, the legatee has a vested interest and is entitled to the income therefrom during the period of administration and settlement of the estate. The amount of such income is reported by the fiduciary as accruing to the legatee and is not taxed as a part of the income of the estate during the period of settlement.

INCOME OF ESTATES OR PROPERTY HELD IN TRUST. The 1916 Law provides that "income of estates or any kind of property held in trust," received during the period of administration or settlement, "including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust," shall be subject to the normal and additional tax and be taxed to the estate, "the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the * * * trustee." Where, however, the income is to be distributed annually or regularly among existing heirs, legatees, or beneficiaries, the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

Procedure in Reporting Undistributed Income. It seems from the provisions of the 1916 Law and the

[32] Act of September 8, 1916, § 2 (b).

rulings which have been made from time to time under the 1913 Law, that all of the net income of an estate, for each calendar year, shall be accounted for and be subject to tax. If the income is distributed to or set aside for the beneficiaries, they will report the amount of their respective shares as a part of their income. If the beneficiaries are known, and the intent of the will or deed of trust is that the income shall be distributed annually or regularly among them, such beneficiaries, their respective shares of such income being determined, should add the amount thereof to their other income for the year and pay the tax accordingly, whether or not their respective shares are actually paid to them. The trustees, in such cases, will report that the shares have been credited to the beneficiaries and treat the amounts in the same manner as though actually paid out. If any part of the income is not distributed annually, because the various interests therein are not known, the estate, as an entity, will be reported as the beneficiary of that portion of the net income and the tax will be paid thereon by the fiduciary. Where estates are administered for the purpose of accumulating income for minor beneficiaries, or other persons with contingent interests, the annual income will be considered as income of the estate, from year to year, assuming thereupon the status of capital or corpus of the estate. If the final disposition of each year's income is certain, that is, the identity of the beneficiaries who will receive it is known, so that their respective shares of such income can be segregated and set aside, for income tax purposes, the returns may be made, and the tax paid, in accordance with the respective tax liabilities of such beneficiaries. In short, the purpose of the 1916 Law is to tax the estate, as an entity, on all of that income for

any year which cannot be definitely and legally assigned to some beneficiary as his income. For the purpose of the income tax, an accumulation of income, in the hands of a trustee, which cannot be taken or treated by some taxable person as his income, is income to be taxed to the estate.[33] If the net income is, and legally can be, returned for the purpose of the tax by a beneficiary other than the estate or trust, it is taken out of the class of undistributed income.

RECEIVER. A receiver in partition proceedings is required to report at the close of each year during the pendency of the partition suit, the net income collected from the property during such year, and pay the tax thereon.[34] Where an executor under a will is also receiver in partition proceedings the income accruing to him as receiver should be reported separately and not added to the income received by him as executor, if the receivership is separate and apart from the matter of administration and settlement of the estate.

Specific Exemption to Trust Estates. Before assessing the tax on undistributed net income received during the period of administration or settlement of the estate of a deceased citizen or resident of the United States, or on the undistributed income of trust or other estates of citizens or residents of the United States, the sum of $3,000 is allowed under the 1916 Law, and $1,000 under the 1917 Law, as a specific exemption, in addition to the deductions provided by law for determining the

[33] See T. D. 2231, and letter from Treasury Department dated October 19, 1915, I. T. S. 1917, ¶ 581.

[34] Letter from Treasury Department dated March 14, 1917; I. T. S. 1917, ¶ 2171.

net income.[35] This specific exemption, it seems, is applicable to all trust estates where the decedent was a resident or citizen of this country, or the trust was created by a resident or citizen of this country, and is not dependent upon the status of the persons who may have a contingent interest in the undistributed net income. Where the beneficiaries are known, the guardian, trustee or other fiduciary, making a return for the beneficiary, is allowed to claim the same personal exemption on behalf of each beneficiary as the beneficiary would be entitled to claim if the return were made by him.

Returns by Fiduciaries. Fiduciaries are required to make the return of annual net income on or before March 1, in each year, covering the income received by the trust estate during the preceding calendar year. This return is required to state the total amount of income received, (except exempt income) the allowable deductions claimed against such income, the net income, and the respective amounts distributed to the respective beneficiaries or retained by the estate as undistributed income.[36]

By Whom Filed. The return is filed by the fiduciary having charge of the trust estate. In making the return, and in all other respects, he is subject to all the provisions of the law which apply to individuals. Where there are two or more joint fiduciaries of a trust estate, the return may be made by one of the fiduciaries

35 Act of September 8, 1916, § 7, as amended by Act of October 3, 1917, and § 3, Act of October 3, 1917.

36 Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917. See also Form 1041, prescribed for use of fiduciaries.

and such a return is a sufficient compliance with the requirements of the act.[37]

WHEN A RETURN IS REQUIRED. A return is required whenever the income payable to any one beneficiary including dividends exceeds the minimum specified by law.[38] The 1916 Law provides that no return of income not exceeding $3,000 shall be required "except as in this title otherwise provided." The 1917 Law provides that a return shall be required in case of net incomes of $1,000 or over, in the case of unmarried persons, and $2,000 or over in the case of married persons. No ruling has yet been issued construing these provisions. Under the 1913 Law a fiduciary return was required where any beneficiary's interest was $3,000 or over, and it would seem that under the present law a return is required whenever any beneficiary's interest, or the amount of the undistributed income, exceeds $1,000.[39] In the 1913 Law there was no specific provision taxing the undistributed income of decedents' estates, and it was held that no return need be made by fiduciary until the settlement of the estate had reached a stage where the beneficiaries thereof and their respective interests in the income of the estate were determinable, and thereafter a fiduciary was required to file a return on or before March 1st of each year.[40] The present law requires a return annually while the estate is in process of settlement and the payment of the tax by the estate on the undistributed income received during that period.

37 Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917.

38 Letter from Treasury Department dated January 4, 1917; I. T. S. 1917, ¶ 1971.

39 Telegram from Treasury Department dated February 1, 1916; I. T. S. 1917, ¶¶ 637 and 638.

40 T. D. 1943.

FIDUCIARIES ACTING IN MORE THAN ONE ESTATE. Where a fiduciary acts for a beneficiary in more than one estate or trust each estate requires a separate return [41] unless the creator of the trust in each instance is the same person and the trustee in each instance is the same person, in which case, the trustee may make a single return for all the trusts in his hands, notwithstanding the fact that they arise from different instruments. This ruling is based on the identity of the creator and the identity of the trustee of the various trusts, and not upon the identity of the beneficiaries.[42]

WHERE FILED. The return of annual net income should be filed in the collection district in which the fiduciary resides or has his place of business, regardless of the residence of the beneficiaries. Where an estate has two or more joint fiduciaries the return may be filed by one of them, in the district where he resides, such filing being sufficient compliance with the law.[43]

WHEN FILED. The annual return must in all cases be filed on or before March 1 of the year following that for which the income is reported. Although a fiduciary may be a corporation, no privilege is extended for the filing of the return for any other period than the calendar year. The same general rules applicable to the filing of returns by individuals apply to the returns by fiduciaries. The same extension of time may be granted, and the same penalties are imposed for failure to file returns.[44]

41 T. D. 2090.

42 T. D. 2137.

43 Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917.

44 See Chapter 35.

PREPARATION OF ANNUAL RETURN. The annual return of a trust estate is prepared in the manner indicated on the form supplied by the Government. No special rules are applicable to fiduciaries, except that where the fiduciary still retains income received during the year, and the beneficiary is known, the return should show the amount actually paid to the beneficiary during the year and separately the amount to which the beneficiary is entitled, but which has not actually been paid over.[45]

HOW SIGNED AND SWORN TO. The law provides that the fiduciary shall make oath that he has sufficient knowledge of the affairs of such person, trust, or estate to enable him to make such return and that the same is, to the best of his knowledge and belief, true and correct.[46] When the return is signed and sworn to by an individual as a fiduciary his full address must be stated. If the fiduciary is an organization, the return shall be signed and sworn to by the president, secretary or treasurer.[47]

Returns for Beneficiaries. As a general rule the fiduciary is not required to make any return for and on behalf of his beneficiary. If, however, the fiduciary has been legally authorized to act as agent for the beneficiary, or as attorney-in-fact, he may also make and file the personal annual return of the beneficiary in the same manner as any other duly authorized agent may do.[48] If the beneficiary is incapable of making his own

[45] Letter from Treasury Department dated February 18, 1916; I. T. S. 1917, ¶ 639.

[46] Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917.

[47] Reg. 33, Art. 73.

[48] Reg. 33, Art. 72.

return, or is a non-resident alien, the fiduciary is required to make the personal return for him, as indicated in the following paragraphs.

For Minor or Insane Person. Where the fiduciary acts for a single beneficiary who is a minor or an insane person, he is not required to file a fiduciary return for the trust estate but will make a personal return for his ward on the form prescribed for individuals. If, however, a fiduciary has more than one ward by reason of the same estate or trust, he makes the fiduciary return, and also a separate return for each ward having a net income of $1,000, if unmarried, or $2,000, if married.[49] In all cases where fiduciaries act for minors or incompetents they are held for the purpose of the income tax to be acting as the agents of such minors or incompetents and must pay all tax, normal and additional, chargeable on such income in their hands, as though the persons for whom they act were acting for themselves.[50] In the year in which a minor becomes of age, the guardian should make a fiduciary return for the period between the beginning of the year and the day on which the beneficiary becomes of legal age. At the close of the year the beneficiary makes his own return including therein the amount of income received from the fiduciary during the year.

For Non-Resident Alien Beneficiaries. When there is only one beneficiary, who is a non-resident alien, the fiduciary files only one return, that is, the personal annual return for and on behalf of the non-

49 T. D. 2090.
50 T. D. 2231.

resident alien,[51] signing the same as agent, reporting therein as income of the non-resident beneficiary the amount received by the estate or trust. If there are two or more beneficiaries, or if a part of the income accruing to the trust or estate is not distributed, the fiduciary is required to make a return as fiduciary and a separate personal return for each non-resident alien beneficiary.[52] The fiduciary must account for the normal and additional tax of non-resident alien beneficiaries in the same manner as any other agent for a non-resident alien is required to do.[53]

Income to Be Reported by Beneficiary. As stated in the foregoing part of this chapter unless the beneficiary is under some disability which requires a fiduciary to act, the beneficiary makes his own personal return and accounts for the tax upon his entire net income, including that which has been received from the estate.[54] The fiduciary is not under any duty to account for or pay the tax on amounts distributed to beneficiaries where the beneficiary is capable of making his own return and is not a non-resident alien. The beneficiary reports the income for the year in which it is received by him or credited to him. The amount to be reported by the beneficiary, as his income from the trust estate, is the amount actually received from the fiduciary or actually credited to him, as his income, by the fiduciary, that is, the actual amount of income to which he obtains legal title during the year.[55]

51 Form 1040 is the form to be used for this purpose.

52 T. D. 2313.

53 See Chapter 6.

54 T. D. 2090.

55 Act of September 8, 1916, § 2 (b).

Withholding at the Source Against Fiduciaries. The provisions with respect to withholding the tax at the source apply in the case of payments to fiduciaries in the same manner as in the case of payments to individuals. There is, generally speaking, no withholding at the source on payments to citizens and residents of this country and, it follows; there is no withholding at the source in the case of a fiduciary who is a citizen or a resident, or has an office or place of business in this country. The one exception to this rule is the withholding of one 2% normal tax on interest paid on obligations of corporations containing a tax-exempt covenant. In such cases the tax is in theory withheld, but not in actual fact, since the paying corporation assumes the burden of the tax, paying the interest in full to its bondholder. Although the fiduciary may be a corporation, in its capacity as fiduciary, it is subject to the provisions of law applicable to individuals and not to corporations, hence on payments of such interest as that referred to in the preceding sentence, the paying corporation will be required to treat the corporation fiduciary as an individual and assume the burden of the 2% tax.[56]

Withholding at the Source by Fiduciaries. A fiduciary is under the same duty to withhold the tax at the source as is an individual, partnership or corporation, that is, the tax is withheld at the source upon all annual or periodical payments of fixed and determinable income to non-resident aliens in the manner required by the law.[57] No withholding by a fiduciary

56 See Chapter 41 on collection at the source.

57 Id.

is required in the case of payments to citizens or residents of this country or to corporations or partnerships.

Information at the Source. The fiduciary is subject to all the provisions of the law requiring information at the source. These requirements are discussed in full in a subsequent chapter.[58]

[58] See Chapter 40 on information at the source.

CHAPTER 9

FOREIGN FIDUCIARIES

The law provides that "guardians, trustees, executors, administrators, receivers, conservators, and all persons, corporations, or associations, acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals."[1] The law implies that foreign fiduciaries shall be subject to its provisions to the same extent as non-resident alien individuals. The term "foreign fiduciaries" is defined, for the purpose of this book, as fiduciaries who neither reside in this country nor have an office or place of business here, that is, those who are not within the jurisdiction of this Government. The preceding chapter contains the general rules relating to fiduciaries. This chapter treats of the application of those rules to foreign fiduciaries. As to who are fiduciaries and who are beneficiaries within the meaning of the law, and as to the special duties of executors, administrators and receivers see the preceding chapter.

Trust Estates. The trust estate under the control of a foreign fiduciary is subject to tax on net income derived from sources within this country. Net income from

[1] Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917.

sources within this country is determined under the same rules as apply to non-resident aliens.[2] The deductions claimed by the foreign fiduciary are governed by the rules relating to fiduciaries in general, except so far as they are limited by rules relating to deductions of non-resident aliens.

Distribution of Income of Trust Estates. A foreign fiduciary having charge of an estate or trust, the net income of which is distributed annually or periodically among non-resident alien beneficiaries, is required to execute the same annual return [3] as is required of domestic or resident fiduciaries and a personal return [4] on behalf of each non-resident alien beneficiary.[5] If the foreign fiduciary has only one beneficiary who is a non-resident alien to whom all of the income is distributed annually it is necessary to file only the personal return on behalf of the beneficiary and not a return for the trust estate. If the foreign fiduciary acts for beneficiaries who are citizens or residents of this country no personal return need be filed on behalf of such beneficiaries, but a return of the trust estate must be filed, showing the names of such beneficiaries, among others, and amounts of income distributed to them during the year. The discussion in the preceding paragraph on the subject of distribution of income of trust estates should be read in this connection.

Undistributed Income of Trust Estates. For the meaning of the term undistributed income of trust estates

2 See Chapter 5.

3 Form 1041.

4 Form 1040.

5 Letter from Treasury Department dated December 28, 1916; I. T. S. 1917, ¶ 1963.

see the discussion in the preceding chapter. If a foreign fiduciary has charge of an estate in process of administration or settlement, or a trust estate in which net income from sources within the United States remains undistributed at the close of the calendar year, a return is required [6] listing the estate as beneficiary of such undistributed net income. The tax will thereupon be assessed on the undistributed income against the estate as an entity and the fiduciary will be required to pay both normal and supertaxes thereon.[7] If the estate was created by a citizen or resident of this country, the nonresident alien may claim a specific exemption from the net income thereof, as indicated in the preceding chapter, but if created by anyone not a citizen or resident, no such exemption may be deducted.

Return of Annual Net Income. Foreign fiduciaries are required to make a return of the annual net income of the estate from sources within this country, on or before March 1 in each year covering the income received by the trust estate during the preceding calendar year. This return is required to state the total amount of income received from sources within this country (except exempt income,) the deductions claimed against such income, the net income, and the respective amounts distributed to the beneficiaries or retained by the estate as undistributed income.

BY WHOM FILED. The return is filed by the fiduciary having charge of the trust estate. In making the return he should comply with the law and regulations

6 Letter from Treasury Department dated December 28, 1916; I. T. S. 1917, ¶ 1963.

7 See Chapter 10 on undistributed income of trust estates.

respecting returns by non-resident aliens. Where there are two or more joint fiduciaries of a trust estate the return may be made by one of the fiduciaries.[8]

WHEN A RETURN IS REQUIRED. It seems that the law requires a return whenever the net income from sources within this country payable to any beneficiary, or remaining undistributed at the end of the year is $1,000 or over.[9]

WHERE FILED. In the case of foreign beneficiaries the return should be filed with the Collector of Internal Revenue at Baltimore, Maryland.

WHEN FILED. The annual return must in all cases be filed on or before March 1 in the year following that for which the income is reported. The same general rules are applicable to the filing of returns by non-resident aliens and by foreign fiduciaries. The same extension of time may be granted and the same penalties are imposed for neglect or failure to file.[10]

Withholding at the Source Against Foreign Fiduciaries. The provisions with respect to withholding the tax at the source apply, in the case of payments to foreign fiduciaries, in the same manner as in the case of payments to non-resident aliens. A foreign fiduciary cannot claim exemption from withholding of the tax at the source,[11] but may claim the benefit of deductions

8 Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917.

9 See the discussion under this heading in Chapter 5.

10 See Chapter 35 on return of annual net income.

11 Letter from Treasury Department dated December 28, 1916; I. T. S. 1917, ¶ 1963.

and credits, and obtain a refund of any amounts withheld in excess of the tax liability of the estate, in the same manner as is prescribed with respect to non-resident alien individuals.[12]

Withholding at the Source by Foreign Fiduciaries. Since a foreign fiduciary is not personally within the jurisdiction of this Government it seems that the requirements imposed upon others to withhold the tax in paying net income to non-resident aliens, do not apply to such fiduciaries. A foreign fiduciary is required to report the names of the beneficiaries of the trust estate upon which information the Government will collect the tax from the beneficiary.

Information at the Source. It does not seem that a foreign fiduciary is under any duty to supply the Government with information at the source as to payments made to others, except so far as information is supplied with respect to beneficiaries by the return of annual net income. In any event there is no duty imposed upon the foreign fiduciary until demand is made by the Commissioner of Internal Revenue for such information.

12 See Chapter 5.

CHAPTER 10

PARTNERSHIPS

The law provides for the taxation of individuals and corporations. Partnerships, as such are not taxable, but persons carrying on business in partnership are liable for the income tax, in their individual capacity, on the share of the profits of the partnership to which they are or would be entitled as partners, whether the profits are divided or kept in the business.[1] Section 10 of the 1916 Law, imposing the tax on corporations, expressly excludes partnerships. This, however, has been held by the Treasury Department to mean only general partnerships such as were known to and existed under the common law. All other forms of partnerships are taxed in the same manner as corporations. For the purpose of the discussion in this and the following chapter, general partnerships are divided into two classes, domestic and foreign. A domestic partnership is defined as one which has its principal place of business in this country and directs all or the greater part of its business from its office or offices in this country, whether or not the partners are citizens or aliens, residents or non-residents. The definition of "foreign partnership" is found in the following chapter.

Limited Partnerships. Limited partnerships are held to be in the same category as corporations or associa-

1 Act of September 8, 1916, as amended, § 8, Subdivision (e); T. D. 1957.

tions and subject to the income tax imposed on such entities. The profits of limited partnerships so reporting are treated as dividends and are not subject to the normal tax in the hands of the partners receiving them.[2] A limited partnership is a form of business organization created by statute in many of the United States, wherein the liability of certain special partners, who contribute a specific amount of capital, is limited to the amount so contributed, while the general partners of the same partnership are jointly and severally responsible as in ordinary partnerships. The purpose of a limited partnership is to protect the special partner and to enable him to employ his wealth in trade without risking more than he originally contributed. As thus defined, a limited partnership has always one or more partners who have contributed the capital to the firm, and are therefore entitled to receive a portion of the profit, yet who are unknown in the management, and, so far as the conduct of the business is concerned, may be said to occupy a position analogous to that of stockholders in corporations. In such limited partnerships there exists no element of principal or joint agency so far as the special partner or partners is concerned and the only element of agency found in the business is among the general partners. The Treasury Department therefore holds that a limited partnership may very properly be classed as a quasi-corporation or association within the meaning of the law.[3]

[2] Reg. 33, Art. 86; T. D. 2137. Under the 1909 Law it was held that a limited partnership was liable for the tax, if organized for profit and having a capital stock represented by shares, although no ''certificates of stock'' were issued. (Op. Atty. Gen. Feb. 14, 1910.)

[3] In a letter dated January 19, 1916, written with particular reference to limited partnerships of the type created under the

Dividends from Limited Partnerships. Since a limited partnership is treated as a corporation and is required to make returns in the same manner as corporations, its profits should be treated by the members of the partnership the same as dividends of corporations.[4] Members of limited partnerships should therefore ascertain if the partnership is paying a tax according to this requirement and if so the normal tax should not again be paid on their shares of the profits.

Partnership Associations. Under the Corporation Excise Tax Law of August 5, 1909, the Attorney General held that partnership associations organized under the laws of Pennsylvania, possessing every privilege and

New York Statute, Laws of 1897, Ch. 427, § 3D, the Treasury Department gives its reasons for classing limited partnerships with corporations. After quoting the language of what is now § 10 (a) of the Act, which imposes a tax on "every corporation, joint stock company or organization or insurance company * * * but not including partnerships" the letter states that the term "partnership" as there used is a common law term and applies only to such partnerships as were known to the common law. A limited partnership is a distinct creature of the statutes of the several states and while it possesses some of the characteristics of the common law partnership, it possesses other distinct characteristics which render it more in the nature of an association—that is a corporation in form, without a specific charter. Corporations, joint stock companies, associations and limited partnerships are all held to be entities and only those entities which are specifically enumerated in the Act as exempt from its requirements can be relieved from liability under the law. Since Congress had in mind, evidently, only common law partnerships in providing for the exemption of this class of business organizations it follows that any other organization, particularly such an entity as exists by reason of statutory provision, does not come within the exemption provided.

[4] T. D. 2137.

power essential to a corporation were properly taxable as corporations.[5] Such associations have capital contributed by the partners, who are not individually liable beyond the unpaid capital subscribed by each. The other characteristics which are more in the nature of a corporation than of a partnership are that the word "Limited" must be a suffix to the name, the interest of a partner may be transferred and new partners may be taken in by vote of a majority of the partners, and the association may sue or be sued in the association name.

PRIVATE BANKS. Private banks which transact business not in the name of the bank but in the name of individuals who compose the firm are held to be copartnerships and as such are not required to make returns. If, however, the bank has the form of a corporate organization, elects officers and a board of managers, has a distinct name, a fixed situs, and distributes its net earnings upon the basis of the amount of capital invested by the members or owners, it is held to be an association within the meaning of the law and is required to make returns as such, unless the bank is owned entirely by one man, in which case it is treated as the business of an individual.[6]

General Partnerships. A general partnership, or what is known as a common law partnership, which Congress clearly intended to be exempt from the requirements of the income tax law, is one which does not have a separate entity, but is composed of two or more individuals associated together for the purpose of carrying

[5] 28 Op. Atty. Gen. 189 (1910).
[6] T. D. 2137.

on a given business or transaction. Such a partnership has been defined by the courts as "a business organization in which every partner possesses full power and absolute authority to bind all the partners by his acts or contracts in relation to the business of the firm, in the same manner and to the same extent as if he held full power of attorney from them." Among the principal elements of a general partnership are community of ownership of the partnership property, mutual responsibility and powers in the conduct of the partnership business, mutual liability, joint and several, for the debts of the partnership and mutual interest in the profits of the same. Such partnerships are not subject to the tax, but the partners are taxed on their respective shares of the profits.[7]

Partnerships Operating Abroad. No distinction is made in the law or regulations between domestic partnerships which operate entirely within this country and those which operate partly abroad. A partner's share of the net profits of the partnership is in all cases taxable in full if the partner is a resident or citizen of this country. If a partner is a non-resident alien many questions arise as to the extent to which he is properly taxable on the gains from business of the partnership conducted abroad. If the partnership is a limited partnership association under the provisions of some statute, the Government will undoubtedly hold that the partner is taxable to the same extent as though it were a corporation, but if it is a general partnership operating partly in a foreign country, the entire income therefrom can scarcely be considered as income arising within the United States even though the partnership has an

[7] Reg. 33, Art. 94.

office in this country and the income is paid to the partner from that office, since a general partnership is not a separate entity interposed between the individual and the source of the income.

Procedure in Collecting Income. A domestic partnership is not subject to the withholding at the source, since it is not the income of the partnership but the income of the respective partners which is subject to tax. Therefore the provisions of law relating to collection at the source do not apply to partnerships, except to the extent that a partnership may be required to establish its identity and status by filing a certificate or statement showing it to be a partnership, upon the filing of which no tax will be withheld.[8] Partnerships as well as all other recipients of income will be required to disclose their identity in the case of receiving fixed and determinable income from another under the provisions of law as to Information at the Source.[9]

Duty in Paying Out Income. A partnership is under the same duty in paying out income as is an individual or a corporation, that is, in all cases required by law the tax must be withheld upon payments to non-resident aliens and information as to the name and address of the recipient must be obtained upon payment to other individuals or corporations and partnerships.[10]

Net Income of Partnerships. While the law is silent as to the manner of computing the net income of part-

8 T. D. 1957; T. D. 1998. See Chapter 41 on Collection at the Source.

9 See Chapter 40 on Information at the Source.

10 See Chapters on Collection at the Source and Information at the Source.

nerships it follows that since the partners are subject to tax on the distributive shares of the profits, the net income should be ascertained in general under the same rules as apply to individuals.[11]

Deductions. The deductions to which a partnership is entitled are not stated in the law, but it would seem that deductions of expenses, interest, taxes, losses, depreciation and depletion should be made by general partnerships under rules applicable to individuals. In the case of limited partnerships reporting as corporations, the deductions should be made under the rules applicable to corporations. Such special rulings as have been made with respect to deductions of partnerships are given below.

Profit Sharing. Where a partnership agreed with an expert to take charge of one of its departments upon a participation of profits basis by which the expert served without salary and received his compensation in the form of 20% of the net profits of the department at the end of the year, it was held that this arrangement established the relation of employer and employee, not that of partner, and that the amount of compensation paid to the expert constituted a proper item of business expense to be deducted in computing the taxable income accruing to the partnership members.[12]

Insurance Premiums. Premiums paid on life insurance policies covering the lives of partners or employees

11 This manner of determining net income is expressly required of partnerships in making the special returns which the law authorizes the Commissioner of Internal Revenue to demand at any time. Act of September 8, 1916, § 8 (e).

12 Letter from the Treasury Department dated June 30, 1916; I. T. S. 1917, ¶ 512.

are not permitted to be deducted in computing the profits of a partnership for the purpose of determining the distributive shares of the partners.[13] On the maturity of such policies the amounts of premiums so paid (if not deducted from the net income of the years in which paid) will be a proper deduction from the amount of the policy, the remainder constituting the taxable portion of the amount received.

INTEREST. Partnerships may deduct interest paid during the year to the same extent as individuals, and subject to the same limitation in the case of interest paid on money borrowed for the purchase of bonds the interest on which is exempt as income.[14]

Distribution of Partnership Profits. The law has not been construed at any time to require the collection of the tax at the source on the distribution and payment of profits of a partnership to the partners. No ruling has yet appeared requiring such deduction on payments to non-resident alien partners.[15]

Profits to Be Reported by Partners. The annual net profits of a partnership when divided and paid to the

13 Act of September 8, 1916, as amended by Act of October 3, 1917, § 32. Under the 1916 Law prior to this amendment the Treasury Department permitted such premiums on life insurance to be deducted from year to year as paid and required the amount of the policy to be included in gross income in the year in which the policy matured and such amount was received. (T. D. 2090.)

14 See Chapter 29.

15 If a non-resident alien partner fails to pay the tax on his share of the profits, the partnership might be held liable as a resident agent having custody and control of such income, but the Treasury Department does not seem so far to have required any

members should be included by each individual partner receiving the same in his annual return and the tax paid thereon as required by law. Both normal and supertaxes must be paid, except as noted below. When the annual profits are not distributed and paid to the partners, the respective interests of each partner in the undistributed profits for the year should be ascertained and the partners entitled thereto should include the amount of their respective interests in their annual returns as if the profits had been distributed and paid to them.[16] Such undivided annual profits of partnerships having been reported by the individual members thereof and the tax having been paid thereon, are not again taxable to the partners when actually distributed at a later date.[17] The distributive interests of the partners in the firm's net income should be the amount shown by the books when closed and not their distributive interests in the amount of income of the partnership represented by actual cash receipts, unless the partnership keeps its books on the basis of cash receipts and disbursements. Where accounts receivable, for instance, are entered on the books of the partnership as income and the amounts thereof are treated as debts due from customers or clients, the partners' returns are required to be based on the total sum of such accounts receivable and not on the amount thereof that has actually been paid.[18]

action to be taken to withhold the tax at the time of payment. See I. T. S. 1917, ¶ 2282.

16 Reg. 33, Art. 13.

17 Reg. 33, Art. 14.

18 Letter from Treasury Department dated February 28, 1916; I. T. S. 1917, ¶ 521.

INTEREST ON NATIONAL BONDS. A partner may deduct from his net distributive interest in the partnership a proportionate amount of the income received by the partnership on the obligations of the United States, if and to the extent that it is provided in the act authorizing the issue of such obligations that they are exempt from taxation. This provision is no doubt intended to grant the same exemption to partners as is granted to individuals under the provision of Section 4 of the 1916 Law as amended. That section, however, permits the deduction of interest on the obligations of the United States whether or not the act creating the obligation provides that the obligation shall be exempt from tax, except in the case of obligations issued after September 1st, 1917. Congress undoubtedly had in mind that partners should be allowed to deduct the interest on obligations of the United States issued prior to September 1st, 1917, whether or not the act authorizing such issue specified that the obligations would be exempt, although a strict construction of the provision applying to partnerships would seem to prohibit the deduction in all cases unless the authorizing act contained a clause exempting the interest.[19]

INTEREST ON BONDS OF THE STATES, POSSESSIONS AND POLITICAL SUBDIVISIONS. The interest received by the partnership on the obligations of a state or any political or taxing subdivision thereof and upon the obligations of the possessions of the United States may be deducted by a partner in proportion to his share of the total partnership profits. This is undoubtedly intended to give the partner the benefit of the same exemption as

19 Act of September 8, 1916, as amended by Act of October 3, 1917, § 8, Subdivision (e).

is accorded to individuals or corporations under Section 4 of the 1916 Law, although that section refers only to "political subdivisions while the provision relating to partnerships refers to "political and taxing subdivisions." However, political subdivision has been construed to mean any subdivision of a state having the power to levy taxes so that the inclusion of the phrase "taxing subdivision" does not seem to extend any greater exemption to partners than to others.[20]

DIVIDENDS. For the purpose of computing the normal tax a partner is allowed a credit for his proportionate share of the income derived by the partnership from dividends.[21] Although this provision of the law seems to permit a credit of all dividends, it is undoubtedly intended to be limited to dividends on the stock of corporations subject to this tax, since the credit to be allowed is that provided by section 5, subdivision (b), of the same act which is specifically limited to such dividends. The rate of supertax on dividends depends on the year in which the profits were earned by the corporations.[22]

Fiscal Year. A partnership has the same privilege of fixing and making returns upon the basis of its own fiscal year as is accorded to corporations. If a fiscal year ended during 1916 or ends during a subsequent calendar year for which there is a rate of tax different from the rate of the preceding calendar year, the rate for the preceding calendar year applies or shall apply

[20] See Chapter 29 on Deduction of Interest.

[21] Act of September 8, 1916, § 8, Subdivision (e), as amended by Act of October 3, 1917.

[22] See Chapter 23.

to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such preceding calendar year bears to the full fiscal year and the rate for the calendar year during which such fiscal year ends shall apply to the remainder of such profits.[23] As an illustration of this provision, assume that a partnership closed its fiscal year on June 30, 1916. In such case after each partner has determined the share of the profits to be reported he will be permitted to divide the amount by two (since one-half of the fiscal year was in 1916 and one-half in 1915) and pay at the 1915 rates on one-half and at the 1916 rates on the other half. Similarly in the case of a fiscal year ending in 1917 the 1916 rates will apply to such proportion of the profits as the part of the fiscal year in 1916 bears to the whole fiscal year. Prior to this amendment of the statute the Treasury Department held that where the fiscal year of a partnership ended at any time other than December 31st the total profits of the partnership were required to be reported as income for the calendar year in which the fiscal year of the partnership ended.

Profits Earned Prior to March 1, 1913. In a case arising under the 1913 Law it was contended that where the fiscal year of a partnership ended between March 1, 1913, and December 31st of the same year, the equitable method would be to apportion the profits for the fiscal year in equal monthly instalments and allot to the period preceding March 1st its proper proportion, making the partners taxable only on their respective shares in the remainder. The court held that the plaintiff

[23] Act of September 8, 1916, § 8 (e), as amended by Act of October 3, 1917.

in this case failed to show that profits were earned by the partnership prior to March 1, 1913, and in what sum, and in the absence of such showing the court assumed that the tax was legally collected.[24] The Treasury Department held under the 1913 Law that the entire amount of profits accruing to a partner at the close of the fiscal year of the partnership were taxable in the calendar year in which the fiscal year ended,[25] although a part of the fiscal year may have covered a period prior to the incidence of the tax.

Net Losses of Partnership. Where the books of a partnership show a loss for a year in accordance with the actual facts, the respective members of the partnership should include as a deduction such amount as is charged against them respectively, as the loss of a partnership is considered to be a loss incurred in trade by the individual members. The partner may deduct the loss whether he is compelled to make good his proportionate share by payment of money to the partnership or whether the loss is charged against profits accrued to his account in preceding years.[26] If the loss occurs in a fiscal year covering a period in which there is a change of tax rates it does not seem that the loss should be pro-rated although the income if any would be, since a loss is deductible in the year in which it is actually sustained.[27]

Returns by Partnerships. Partnerships as such are not required to render returns of annual net income.

24 Cohen v. Lowe, 234 Fed. 474.

25 T. D. 2090.

26 Letter from Treasury Department dated February 12, 1915; I. T. S. 1917, ¶ 522.

27 See Chapter 31 on Losses.

They are, however, required to report annually the amount of tax withheld on income paid to non-resident aliens under the provisions of law requiring collection at the source,[28] and to file such annual returns as are required under the provisions relating to information at the source.[29]

Special Returns. Any partnership when requested by the Commissioner of Internal Revenue or any collector is required by law to make a correct return of its earnings, profits and income, showing the gross income and the deductions and credits allowed by the law and the names and addresses of the individuals who would be entitled to the net earnings, profits and income if distributed. It is not required in such special returns that the partnership report income exempt under Section 4 of the 1916 Law.[30]

28 See Chapter 41 on Collection at the Source.

29 See Chapter 40 on Information at the Source.

30 Act of September 8, 1916, § 8 (e); Reg. 33, Art. 12. A special return from partnerships was required generally in 1913, but no return was required for the year 1914 or for subsequent years, except in instances where it was specifically requested by the Commissioner of Internal Revenue or a collector.

CHAPTER 11

FOREIGN PARTNERSHIPS

The law expressly mentions foreign partnerships in only one provision[1] that which requires the withholding of the tax on payments of income from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations, to non-resident alien firms and copartnerships not engaged in business or trade within the United States and not having any office or place of business therein. By implication, however, the income of a foreign partnership from sources within the United States is taxable in the hands of the non-resident alien partners, to the extent included in the distributable share of each, and such is the ruling of the Treasury Department.[2] If the partner is a citizen or resident of this country, he is of course subject to tax upon his entire distributive share of the profits of any partnership of which he may be a member.

Definition. No definition of the words "alien partnership" appearing in the section of the law referred to in the preceding paragraph, is to be found in the law or the regulations. The law refers to "non-resident alien firms" and to "non-resident alien copartnerships"

1 Act of September 8, 1916, as amended, § 13, Subdivision (e).
2 Letter from Treasury Department dated April 7, 1917; I. T. S. 1917, ¶ 2287.

synonymously, and applies the term without regard to whether or not the firm or copartnership is engaged in business or trade within the United States or has an office or place of business in this country. The term apparently has reference to the status of the partners composing the firm, and in this respect it is indefinite, as a firm may be composed of non-resident aliens and resident aliens or citizens. For the sake of clearness in discussing the subject of this chapter, the term "foreign partnership" as used herein is defined as a partnership or firm, whether composed of aliens or citizens, residents or non-residents, which has its principal place of business in a foreign country and directs all or the principal part of its business from its office outside the jurisdiction of the United States.

Limited Partnerships. If the foreign partnership is one of the kind which, if it were domestic, would be treated as a corporation or association, it seems that it should report its net income and pay the tax according to the provisions of the law and regulations applicable to foreign corporations. Having done so, its partners should treat their net distributive shares of the profits as dividends. Since non-resident alien stockholders of a non-resident foreign corporation are not taxable to any extent on the dividends of such corporation, it would follow that the partners of a non-resident foreign partnership or association which is required by the regulations to report and pay the tax as a corporation, would not be subject to any tax on their net distributive shares of the profits. For a statement of the rulings bearing on the subject of partnerships required to pay the tax in the manner of corporations see the preceding chapter on partnerships.

General Partnerships. If the foreign partnership is a general partnership, not having the characteristics which would require it to pay the tax in the manner of corporations, it is not, itself, subject to the tax on income derived from sources within this country, but each of its individual members is subject to the tax on such part of his distributive share of the partnership profits as is composed of income from this country.[3]

RESIDENT FOREIGN PARTNERSHIPS. A foreign partnership which is engaged in business or trade within the United States and has an office or place of business herein is a resident foreign partnership. Being within the jurisdiction of this Government the tax is not withheld at the source upon any payments made to it. For the purpose of establishing its identity and status a form has been provided which may be used to accompany coupons from bearer bonds in order to claim exemption from withholding of the tax at the source.[4]

NON-RESIDENT FOREIGN PARTNERSHIPS. A non-resident foreign partnership is defined as a foreign partnership which does not have any office or place of business within the jurisdiction of the United States. Such partnerships are subject to having the tax withheld on interest from investments in the bonds or similiar obligations of domestic and resident corporations.[5] A

3 Letter from Treasury Department dated December 6, 1916; I. T. S. 1917, ¶ 554.

4 Form to be used is known as Form 1086; T. D. 2374.

5 Act of September 8, 1916, as amended, § 13, Subdivision (e). Although this provision, as amended, has been held not to require withholding against foreign partnerships, since the tax specified therein is not applicable to partnerships, the subject is discussed here on the assumption that Congress will speedily remedy the

strict interpretation of the provision of the act which requires such withholding would seem to make it apply only in cases where a partnership had no office or place of business in this country and the members of the partnership are non-resident aliens. The Treasury Department however has not so construed the language of the law but requires withholding regardless of the status of the partners, if the partnership has no office or place of business here.[6]

Collection of the Tax at the Source. The law does not require the withholding of the tax on payments of income to non-resident foreign partnerships, except in the case of payment of interest on bonds and similar obligations of domestic corporations.[7] Interest on the

defect in the statute and withholding will again be required as formerly under this provision.

[6] It is interesting to note in this connection that immediately after the 1913 Law was enacted and before it was held that partnerships were not subject to withholding, the Treasury Department provided for the use of partnerships an ownership certificate which required a statement of the names and addresses of each of the partners. No such disclosure of the names and of the partners of non-resident foreign partnerships is now required, which indicates that the Treasury Department does not consider the individual status of the partners to be essential in determining whether or not withholding is necessary.

[7] The language of Subdivision (e) of Section B of the Act of September 8, 1916, as amended, is ambiguous. It provides that the provisions relating to withholding of the tax shall be made applicable "to the tax imposed by Subdivision (a) of § 10 upon incomes derived from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations * * * by non-resident alien firms." No tax, as a matter of fact, is imposed upon firms or partnerships by Subdivision (a) of § 10, and consequently it has been ruled that no tax need be withheld. See Note 5, *supra*.

indebtedness of an individual, dividends on the stock of corporations and other income may be paid to a non-resident foreign partnership without deduction. In no case is withholding required on payments to a resident foreign partnership.

Agents for Foreign Partnerships. A resident of this country may for purpose of the income tax occupy the position of an agent for a foreign partnership and in connection therewith be subject to the duties of resident agents as indicated in the chapter on that subject.[8]

Nominal Stockholders. If a foreign partnership is the actual owner of stock of domestic or resident corporations, the partners thereof are subject to the supertax (but not the normal tax) to the same extent as other individuals. The Income Tax Law does not require withholding of the tax from dividends, whether paid direct to a non-resident foreign partnership or through a nominal stockholder. Where the non-resident foreign partnership is the actual owner, and a resident of this country is the nominal holder of the stock, the latter should proceed as indicated in the chapter on nominal stockholders.[9] If a non-resident foreign partnership is a nominal stockholder, a certificate disclosing the actual ownership should be executed and forwarded to the Collector of Internal Revenue at Baltimore, Maryland, in order that the members of the partnership may avoid any liability for tax because of the apparent ownership of such stock.[10]

8 See Chapter 6.

9 See Chapter 7.

10 Telegram from Treasury Department dated June 26, 1917; I. T. S. 1917, ¶ 2278.

Procedure in Collecting Income. A resident foreign partnership in collecting income from interest on bonds should make use of the form which certifies that it is a firm having an office or place of business in the United States and therefore not subject to having the income tax withheld at the source.[11] A non-resident foreign partnership in collecting similar income is required to use the same certificate as is used by non-resident alien individuals.[12] Upon the presentation of this certificate the tax is required to be withheld by the debtor corporation or its paying agent. In collecting any other form of income no prescribed certificate is necessary, but the partnership may be called upon to disclose its name and location for the purpose of supplying the payor of the income with the information which he must transmit to the Government.

Duty in Paying Out Income. Resident foreign partnerships are under the same duty in paying out income to others as are domestic partnerships; that is, they are required to withhold on payments made from the office in this country under the same conditions as would require domestic partnerships to withhold. They are also required to report the names of those to whom they pay fixed or determinable income, in the manner required by law of corporations, partnerships and individuals generally.[12a]

Extent to Which Taxable. Foreign partnerships, unless they are of the kind taxable as corporations, are not taxable, but the partners are required to pay the tax in all cases on their shares of the profits, gains or

11 The official title of this form is Form 1086.

12 This ruling is temporarily suspended. See page 473, note 51.

12a See Chapters 40 and 41.

income arising from sources within the United States. Thus in the case of resident foreign partnerships, the income from the business transacted in the United States and from investments in this country is taxable. In the case of a non-resident foreign partnership, income from investments in this country and gains from the buying and selling of property of any kind in this country are taxable.[13] Net income is ascertained under the rules applicable to non-resident alien individuals.

Annual Returns. Neither resident nor non-resident foreign partnerships are required to file returns of annual net income. Resident foreign partnerships are required to file annual returns reporting the amounts of tax withheld at the source and also annual returns showing the names and addresses of those to whom fixed and determinable income has been paid in the same manner as is required of domestic partnerships and corporations and individuals. Non-resident foreign partnerships are under no duty to withhold the tax on payments to others and under no duty to report names of persons to whom payments of income are made.

Special Returns. Both resident and non-resident foreign partnerships may be called upon by the Commissioner of Internal Revenue to file special returns showing the net income from sources within this country and the distributive shares of the partners in such income, but such returns need not be filed unless the partnership is specifically requested to do so by the Commissioner of Internal Revenue.[14]

[13] Letter from Treasury Department dated December 6, 1916; I. T. S. 1917, ¶ 554.

[14] Letter from Treasury Department dated December 6, 1916; I. T. S. 1917, ¶ 554.

Returns by Partners. The partners of foreign partnerships are required to make a return showing their own distributive shares of the income of the partnership from sources in this country on the same form as is used in reporting other income.[15] If a partner is a citizen or resident of this country he must, of course, include all of his income from the foreign partnership, but if he is a non-resident alien only so much as has been derived from sources within the United States. In making his personal return the partner will follow the procedure outlined for non-resident aliens or the procedure outlined for citizens and residents, as the case may be.

15 Form 1040.

CHAPTER 12

CORPORATIONS

Corporations are taxed as separate entities apart from their stockholders. They are subject only to the normal tax of 2% under the 1916 Law and 4% under the 1917 Law, making a total of 6%. They are not subject to the surtaxes.[1] They are entitled to deduct from their gross income the deductions specified in the law but are not entitled to any specific exemption such as is allowed to individuals. Corporations make returns for the calendar or their fiscal years as they may elect. The mere existence of a corporation during any part of the year is sufficient to require it to make a return.[2] The mere receipt of net income from any source makes it liable for the tax. Doing business is not a necessary element of taxability.[3] The tax is an income tax and not an excise tax.[4]

1 Reg. 33, Art. 185.

2 T. D. 2090.

3 The numerous cases under the 1909 Law holding certain corporations not to be taxable on the ground that they were not "doing business" have no application to the present income tax laws.

4 The tax assessed on corporations for the months of January and February, 1913, under the 1913 Law, was an excise tax and not an income tax and, therefore, applied only to corporations "doing business," but the exemptions and deductions to which a corporation was entitled were those allowed by the 1913 Law, which law did not permit the deduction of dividends. (Butterick Company v. U. S., 240 Fed. 539.)

Definition. The tax is imposed upon every corporation, joint stock company or association, or insurance company, organized in the United States, no matter how created or organized. The word "corporation" as used in this chapter and elsewhere includes joint stock companies, associations and insurance companies.

JOINT STOCK COMPANIES. There seems to be no constitutional or legal objection to including joint stock companies in the same category with corporations.[5] A joint stock company organized under the New York Joint Stock Association Law was held, under the 1909 Law, to be practically a "corporation" by New York law, despite the absence of the important corporate attribute of limited liability, and was held taxable as such.[6]

ASSOCIATIONS. Associations are treated as corporations and include associates, real estate trusts, or by whatever name known, which carry on or do business in an organized capacity, whether organized under and pursuant to state laws, trust agreements, declarations of trust or otherwise, the net income of which, if any, is distributed among the members or other owners on the basis of the capital stock which each holds, or, where there is no capital stock, on the basis of the proportionate share of capital which each has invested in the business or property of the organization.[7]

"SYNDICATES" ARE NOT CORPORATIONS. Where a block of securities are purchased in joint account by

[5] As to including such organizations in the provisions applicable to corporations, see Spreckels Sugar Refining Co. v. McClain, 192 U. S. 397; Flint v. Stone-Tracy Co., 220 U. S. 107.

[6] Roberts v. Anderson, 226 Fed. 7.

[7] Reg. 33, Art. 79.

several corporations, partnerships or individuals for the purpose of disposing of them to the public through the syndicate managers, the only obligation of the members of the syndicate being to take and pay for the portion of the securities not disposed of, such temporary combinations of business interests are neither corporations, joint stock companies or associations, nor partnerships, within the meaning of the income tax law and the profits of the syndicate are not taxable in the hands of the syndicate. The several members pay the tax on their respective shares of the profit of the transaction.[8]

TRUSTS TAXABLE AS AN ASSOCIATION. In the case of a trust created to hold certain land and to dispose of the same and distribute the proceeds to the beneficiaries, the title stood in the names of the trustees who received and distributed moneys, and transacted all of the business connected with the management and control of the trust property. The pro-rata interests of the beneficiaries were represented by beneficial certificates issued to them by the trustees. These certificates could be transferred if the transferee executed and became a party to the original declaration of trust and articles of agreement. The purpose of the trust was to dispose of the land from time to time and pay the net proceeds over to the beneficiaries and the trustees had no power to carry on any other business. It was held that this trust partook of the character of an association and was subject to the tax as an entity.[9]

PRIVATE BANKS. Private banks which have the form of corporate organizations, elect officers and a board of

[8] Letter from Treasury Department dated February 25, 1914

[9] Letter from Treasury Department dated March 14, 1917.

managers, have a distinctive name and fixed situs, and distribute their net earnings upon the basis of the amount of capital invested by the members or owners, are held to be associations within the meaning of the law and are required to make returns and pay the tax as corporations.[10] The net earnings of such organizations are considered as dividends. If, however, the private bank is owned by one man, that is considered as evidence that the bank is not an association. And if a bank does not have the formal organization noted above but transacts business in the names of the individuals who compose the firm, the bank is held to be a partnership.[11]

Residence. Domestic corporations are considered to be residents of this country whether or not their property and business is located within or without this country, with the one exception noted in the following paragraph. No consideration is given by the law or the regulations to the fact that domestic corporations may derive all of their income from sources outside of the United States.[12] The question assumes importance with respect to non-resident aliens deriving income from the bonds of corporations doing business entirely outside of this country and the question of residence is more fully discussed in the chapter on that subject.

10 T. D. 2137.

11 Mimeograph letter to Collectors, No. 1271.

12 In a case under the 1909 Law payment of the tax was refused, the corporation alleging under advice of counsel that because its business was transacted in a foreign country and it had no assets in this country, its stockholders living in the foreign country and its income being spent and invested there, it was not liable for the tax assessed. The Treasury Department proposed to test the question, but after suit was instituted the Company

CORPORATIONS DOING BUSINESS IN THE PHILIPPINES AND PORTO RICO. Corporations doing business wholly in these possessions, even though incorporated in the United States, are held to be resident corporations of these possessions and will make return and pay the income tax to the collector of internal revenue having jurisdiction therein. If a corporation is resident in the United States but doing a part of its business in these possessions, it is taxable only in the United States. If a corporation is organized under the laws of the United States (i. e the federal laws) or under the local laws of the possessions and resident in the possessions, it is required to pay the tax in the Philippines or in Porto Rico, as the case may be.[13]

Corporations Formed During the Year. A corporation organized during the year is required to make a return covering that portion of the year during which it was engaged in business or had an income accruing to it.[14] If the corporation gives proper notice of its selection of a fiscal year, its first return may be made for the period beginning with the date of incorporation and the close of such year. The fact that a new corporation organized in the year has transacted no business does not excuse it from making a return.[15] Corporations which have applied for but not received charters, or corporations which have received charters but have not perfected their organizations, transacted no business and had no income whatever from any source, may upon the pres-

receded from its position and made payment covering the tax and penalties and the action was discontinued. (T. D. 1863.)

13 T. D. 2090.

14 Reg. 33, Art. 84.

15 T. D. 2090.

entation of these facts to the local collector be relieved from the necessity of making returns so long as they remain in this unorganized condition.[16] When a distinct new corporation is organized to take over the property of an old corporation, both corporations will be required to make returns covering the periods of the year during which they were each respectively in charge of the business.[17]

Corporations Merging During the Year. In case of a merger or consolidation of two or more corporations during the year, each corporation is required to make a return of the income received during the year prior to the date of merger and consolidation. If each or any of the component corporations subsequent to the consolidation collects prior existing debts it must include in its separate return all of such collected debts.[18]

Change of Name. The mere change of name does not constitute a new corporation. The returns should be made in the name the corporation bears at the end of the year, with a notation to the effect that the name has been changed, giving both the old and new names.[19]

Corporations Liquidating During the Year. A corporation going into liquidation during any tax period may at the time of such liquidation prepare a "final return" covering the income received or accrued to it during the fractional part of the fiscal or calendar year during which it was engaged in business, and imme-

[16] T. D. 2152.
[17] T. D. 2137.
[18] T. D. 1675.
[19] T. D. 2137.

diately file it with the local collector.[20] Where a corporation, by affidavit or otherwise, has clearly established the fact and satisfied the collector of internal revenue that it is defunct, dissolved or obsolete and is no longer carrying on business and has no property or income, returns will not be required after such condition has been clearly established. Only one showing of this character is required, unless it appears later that the corporation has income within the meaning of the law.[21]

LIABILITY FOR TAX AFTER DISSOLUTION. Corporations in receipt of income during any part of the taxable year, but dissolved prior to the end of the year, are liable for the tax on such income. A corporation dissolved in 1917, prior to the passage of the 1917 Law is liable thereunder, since the law is retroactive to January 1, 1917.[21a] The assets are subject to a lien for the payment of taxes provided the corporation has not been dissolved, and all its assets distributed, prior to the time the list of assessments get into the hands of the collector.

COLLECTION OF TAX FROM ASSETS. Section 3186 of the Revised Statutes, as amended, provides generally with reference to internal revenue taxes that "If any person liable to pay any tax neglects or refuses to pay

20 Reg. 33, Art. 85; T. D. 2090. It was held under the Corporation Excise Tax Law of 1909 that a corporation could not evade liability for the tax by dissolving before the time when it was required to make a return. United States v. General Inspection & Loading Company, 192 Fed. 223.

21 T. D. 2137.

21a Letter from Treasury Department dated November 17, 1917; I. T. S. 1917, ¶ 2496. Brady v. Anderson, 240 Fed. 665.

the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties and costs that may accrue in addition thereto, upon all property and rights belonging to such person.'' The 1916 Law provides (Sec. 22) that ''all administrative, special and general provisions of law, including the laws in relation to assessment, remission, collection and refund of internal revenue taxes not heretofore specifically repealed and not inconsistent with the provisions of this title, are hereby extended and made applicable to all the provisions of this title and to the tax herein imposed.'' Under the Income Tax Law it is the duty of the Commissioner of Internal Revenue to send to each collector a list of the companies liable for the tax in his district showing the amounts for which they are liable within such time that the collector may give the required notice of assessment on or before the first day of June, and upon such lists the collections are made. Under the provisions of Section 3186 above quoted the lien is fixed upon the assets of the corporation when this list comes into the collector's hands. Therefore, if the corporation has distributed all of its assets and become dissolved in the manner provided by law, prior to that time there is nothing upon which the lien can attach, and consequently no lien exists to secure the payment of the tax which may be due from the corporation. Notwithstanding this particular provision for collecting the tax, the remedy is not exclusive, and the Government may resort to the common law method of collecting the same.[22] The dissolution of a corporation does not extinguish its lia-

22 Dollar Savings Bank v. U. S., 19 Wall 227.

bilities and through the courts of equity creditors may pursue its assets into the hands of any person who is not a *bona fide* purchaser. The sale of the entire capital stock of a corporation and the distribution of the proceeds of the sale among the stockholders will not defeat or impair the remedy of creditors, if any debts remain unpaid, as the creditors in that event may pursue the proceeds of the sale in the hands of the respective stockholders and compel each one to contribute prorata toward the payment of the debts to the extent of the moneys received on the distribution.[23] This remedy is open to the Government in the same manner as it is to any other creditor.[24] But if a corporation has gone out of business leaving assets which have been distributed among the stockholders, such assets are not available for collection of the penalty for failure to file returns.[25]

Income Subject to Tax. - Corporations are subject to tax on income received from all sources, except income exempt from the law under the provisions of Section 4 of the 1916 Law, as amended, such as the interest upon obligations of a state or any political subdivision thereof or upon the obligations of the United States or its possessions or securities issued under the provisions of the Federal Farm Loan Act. It would seem also that under the present income tax laws a corporation is exempt from tax on the value of property acquired by gift

[23] Railroad Company v. Howard, 7 Wall 392.

[24] 28 Op. Atty. Gen. 241. In the case of U. S. v. General Inspection and Loading Company (192 Fed. 223, 204 Fed. 657) judgment was entered for tax, penalty and interest under the 1909 Law, notwithstanding the corporation had been previously dissolved.

[25] T. D. 1852.

although it was held under the 1913 Law that the exemption of gifts did not apply to corporations. There is this important difference in the provisions of the two laws relating to gifts namely, that the 1913 Law provided for the exemption of gifts under a provision applicable to individuals only and made no mention of such exemption in the provisions applicable to corporations, while the 1916 Law provides for the exemption of the value of gifts in a section which applies with equal force to corporations and individuals.[26] A corporation reports all of its net income to the collector of the district in which its principal place of business is located and pays the tax in the same district regardless of the fact that it may be doing business in other districts in the states, territories, or possessions of the United States. Where a corporation is engaged in carrying on more than one class of business the gross income derived from the different classes is ascertained according to the rules applicable thereto and the gross income of all classes of business in which the corporation is engaged is taken to be the gross income of the corporation. Thus the gross income of manufacturing companies consists of the total sales of manufactured goods during the year, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year; and mercantile companies proceed similarly in determining their gross income by inventory, adding in each case the income from all other sources.[27] Insurance companies determine their net income by special provisions relating to that class of business, which provisions are discussed

[26] Compare § 4, Act of September 8, 1916, and ¶ B, Act of October 3, 1913.

[27] Reg. 33, Arts. 104 and 105.

in the following chapter. The general provisions as to income applicable both to corporations and individuals are discussed in succeeding chapters on income[28] and only the special provisions applicable to corporations are referred to in this chapter. All receipts by a corporation are not income as is indicated in the following paragraph and also in the chapters on income.

SALE OF CAPITAL STOCK. The amount received by a corporation in exchange for its capital stock is held to be capital of the corporation, whether or not the amount received is equal to or greater than the par value. Such transactions are purely capital transactions and the income is not increased by reason of the sale of the stock at a price greater than its par value.[29]

Deductions from Gross Income Allowed by Law. The statute specifies particularly the deductions which may be made from gross income in ascertaining the net income subject to tax. These deductions are four in number as specified in Section 12 of the 1916 law. The general discussion of the deductions allowed to taxpayers is found in the chapters on that subject.[30] In this chapter reference is made to those provisions having application only to corporations.

Ordinary and Necessary Expenses. A corporation is allowed to deduct all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a

28 See Chapters 16 *et seq.*

29 T. D. 2090.

30 See Chapters 27 *et seq.*

condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity. It will be noted that the expenses permitted by this provision of law are only the ordinary and necessary expenses. Extraordinary expenses are not deductible under this head and if they do not fall under one of the other deductions allowed by law may not be permitted in computing net income, although they may be deductions recognized in accounting practice as a proper charge against the income for the year.

ORGANIZATION EXPENSES. The Treasury Department holds that organization expenses of corporations such as attorneys' and accountants' fees together with fees paid to the state authorities prior to or coincident with the securing of a charter and the incorporation of a company constitute a capital investment, such assets being offset by the asset value of the corporate franchise, an intangible asset of a somewhat permanent character and in many instances of substantial value. Such expenses incident to and connected with the incorporation and organization of the company are not "ordinary and necessary expenses of maintenance and operation" which are the only "expenses" authorized by the law to be deducted.[31]

PAYMENTS IN LIEU OF RENT. This item includes all royalties or other charges, including any interest payment which the corporation is required to make for the

31 T. D. 2499. This ruling is not in accordance with accounting practice, which recognizes the propriety of charging off organization expenses against income over a period of four or five years.

right to use and possess property in which it has no control, interest or equity.

Losses. The second deduction specified in the law permits an allowance for all losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade and a reasonable allowance for reduction in flow of oil and gas wells and depletion of mining deposits. This allowance is similar to the allowance permitted to individuals and is discussed in the chapters on deduction.[32] One ruling on losses, having application only to corporations, is given below.

REDEMPTION OF PREFERRED STOCK. Where a corporation issued preferred stock at par redeemable at 110, the difference appearing on the books of the corporation as a reduction of undivided profits, the transaction has been held to be a capital transaction in which there could be no gain or loss to the corporation and, therefore, the difference between the selling price of the stock and the price at which it was redeemed could not be deducted as a loss.[33]

INSURANCE COMPANIES. The special provisions allowing deductions by insurance companies under this heading are treated in the following chapter.

Interest. There may be deducted, in the case of corporations, the amount of interest paid within the year

32 See Chapters 31 to 34.

33 Letter from Treasury Department, dated April 11, 1917; T. T. S. 1917, ¶ 2208. The ruling is different as to redemption of bonds sold at a discount. See Chapter 31.

on its indebtedness (except indebtedness incurred for the purchase of obligations or securities, the interest upon which is exempt from taxation as income under the law) to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding. In the case of interest paid on indebtedness wholly secured by property collateral tangible or intangible, the subject of sale or hypothecation in the ordinary business of the corporation, as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest may be deducted as a part of the expense of doing business, on an amount of such indebtedness not in excess of the actual value of such property collateral. Banks may also deduct all interest paid within the year on deposits, or on moneys received for investment and secured by interest-bearing certificates of indebtedness.[34]

The meaning of the exception as to indebtedness incurred for the purchase of obligations or securities, the interest upon which is exempt from taxation as income, is discussed in a following chapter on deductions. The arbitrary limitation upon the amount of interest on ordinary indebtedness, having peculiar application to corporations, is discussed in the following paragraphs.

Reason for the Limitation. This arbitrary limitation upon the amount of interest which may be deducted by a corporation is a survival of a provision of the 1909 Law, which imposed an excise tax on corporations meas-

[34] Act of September 8, 1916, § 12.

ured by the amount of income. In construing the 1909 Law the Supreme Court held that it was not in any proper sense an income tax law, nor intended as such, but was an excise tax upon the conduct of business in a corporate capacity, the tax being measured by reference to the income in a manner prescribed by the act itself. In limiting the amount of interest which a corporation could deduct under that law Congress evidently had in view the fact that some corporations carry a current indebtedness exceeding the amount of paid up capital stock and with respect to such corporations intended to limit the interest deduction to so much of the indebtedness as did not exceed the capital. It appears that Congress deemed that where the indebtedness exceeded that capital it should no longer be treated as an incident, but should be considered as a principal object of the corporate activities, and that the operations of such a corporation were conducted more for the benefit of the creditors than of the stockholders. There is no question of the power of Congress to adopt such a basis of distinction.[35] While the reason for such arbitrary limitation was excellent in the case of a tax such as that imposed by the 1909 Law, which could otherwise have been avoided by the conversion of capital into indebtedness, the reason applies with much less force to the present law where the income which is not taxed to the corporation becomes taxable to the bondholder. To the extent, therefore, that a corporation is not permitted to deduct all of the interest paid on its indebtedness such interest is subject to tax both to the corporation and to the bondholder.[36]

35 Anderson v. Forty-two Broadway Company, 239 U. S. 69, reversing 213 Fed. 777.

36 This does not throw a double burden on the bondholder, but it throws an extra burden on the stockholders of the corporation

Interest-Bearing Indebtedness. The interest-bearing indebtedness referred to in this provision of the law does not include preferred capital stock; interest or dividends paid upon such stock is not deductible from gross income.[37] It does not include indebtedness secured by collateral subject to sale, which is referred to in a following paragraph. Under the 1909 Law, if a corporation took title to real property subject to a mortgage but did not assume the indebtedness secured thereby, the interest could be deducted in full, as this would not be a payment by the corporation owning the property subject to such lien on its own indebtedness, because the indebtedness was not its bonded or other indebtedness, but an indebtedness created by a third party and charged as a lien upon the land acquired, subject thereto, by the purchasing corporation.[38] But the 1916 Law does not permit of this construction since it provides that "payments required to be made as a condition to the continued use or possession of property," as the phrase appeared in the 1909 and 1913 Laws, must be with respect to property "to which the corporation has not taken or

who are deprived of earnings to the extent that interest paid to bondholders is taxed to the corporation. The arbitrary limitation results in the creation of a fictitious income on which the corporation is taxed, and since at the present time such fictitious income not only is subject to a heavy income tax but enters very materially into the computation of an extraordinarily heavy excess profits tax, the provision operates with rank injustice in the case of corporations which have an indebtedness greatly in excess of their capital stock. In fact, it seems inevitable that real estate corporations such as the Forty-two Broadway Company, which raised the question under the 1909 Law, will, under the present income tax and excess profits tax laws, incur such heavy tax burdens as to place them in grave danger of insolvency.

37 Act of September 8, 1916, § 12.

38 28 Op. Atty. Gen. 198.

is not taking title, or in which it has no equity." Where a corporation purchases property encumbered by a mortgage or other lien and the amount thereof is a part of and included in the purchase price, upon the payment of which the title vests absolute in the purchaser, the purchaser assumes the indebtedness on the property thus purchased and interest thereon partakes in no degree of the nature of rental or franchise charges and its deduction is limited by the provisions of law.[39] If a corporation has an equity in or is purchasing for its own use the real estate upon which a mortgage is a prior lien and the corporation assumes the payment of interest, the indebtedness will be held to be indebtedness of the corporation within the meaning of the law and interest paid on such mortgage will be deductible only within the limit fixed by the law.[40] Where a corporation is engaged in a business by which it both receives and pays out interest the full amount received must be included as gross income and only the amount within the limit fixed by law may be deducted.[41]

INDEBTEDNESS BEARING DIFFERENT RATES OF INTEREST. Where a corporation has several classes of indebtedness bearing different rates of interest and the aggregate amount of indebtedness exceeds the limit allowed by law, the indebtedness bearing the highest rate may be first considered in computing the interest deduction, and the balance, if any, will be computed on the indebtedness bearing the next lower rate and so on until the interest on the maximum principal allowed has been computed.[42]

39 T. D. 1865.

40 Reg. 33, Art. 148.

41 Altheimer & Rawlings Investment Co. v. Allen, T. D. 2441; Middlesex Banking Co. v. Eaton, 233 Fed. 87.

42 Reg. 33, Art. 151.

Indebtedness Outstanding at Close of the Year. If no indebtedness is outstanding at the close of the year, the maximum deduction allowable on account of interest paid will be measured by an amount of indebtedness not exceeding at any time within the year the entire paid up capital stock outstanding at the close of the year; that is in such case the capital stock outstanding at the close of the year measures the highest amount of indebtedness upon which deductible interest can be computed.[43]

Paid Up Capital Stock Outstanding at the Close of the Year. This phrase means the par value of shares issued as reported in Item 1 of the return form and does not include the surplus carried by the corporation. The full amount of stock represented by the par value of the shares issued is to be regarded as the paid up capital stock, except when such stock is assessable on account of deferred payments, or payable in instalments, in which case the amount actually paid on such shares constitutes the actual paid up capital stock.[44] Where the capital stock of the corporation is issued without par or nominal value, the law provides that the amount of capital stock as represented by such shares will be the amount of cash or its equivalent paid or transferred to the corporation as a consideration for such shares. If such shares have been issued as a bonus in connection with shares of preferred stock, in that event, the par value of the preferred stock will be the limit which may be claimed as paid up capital stock. If both common and preferred are issued for cash or other equivalent consideration, the amount will be the par value of the preferred stock plus

43 T. D. 1960.

44 T. D. 2090; Reg. 33, Art. 95.

the amount actually paid in on the shares issued without par value.[45] Neither in the case of stock issued with a par value nor in the case of stock issued without par value can the amount of paid up capital stock be increased except as new capital is paid in and for which additional shares are issued.[46]

Interest Paid by Banks on Deposits. In the case of a bank, banking association, loan or trust company, the interest paid on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, may be deducted in full. Where a corporation, chartered as a bank, was engaged in the business of selling debenture bonds and guaranteed real estate securities, by a method by which it both paid and received interest, it was held that the interest paid out could not be deducted in full as interest paid on deposits, the transaction in no way being a banking transaction.[47] It seems that such interest can now be deducted as interest paid on indebtedness secured by collateral.

Interest on Indebtedness Secured by Collateral. Such interest may be deducted without limit provided (a) the indebtedness is wholly secured by property collateral, tangible or intangible, (b) such collateral is the subject of sale or hypothecation in the ordinary business of the corporation as a dealer in such property or in

[45] Letter from Treasury Department dated January 13, 1916; I. T. S. 1917, ¶ 1462.

[46] Letter from Treasury Department dated January 13, 1916; I. T. S. 1917, ¶ 1463.

[47] Middlesex Banking Company v. Eaton, 233 Fed. 87.

loaning the funds thereby procured and (c) that the indebtedness does not exceed the actual value of such property collateral. Such interest is deductible not as interest paid, but as an expense of doing business. The interest deducted under this provision of the law must be stated separately in the return of annual net income and must be segregated from indebtedness not so secured. Failure to segregate the two forms of indebtedness will result in a suspension or disallowance of the amount claimed.[48]

COLLATERAL THE SUBJECT OF SALE. This phrase as used in the law refers to tangible or intangible property bound for the performance of certain covenants or payment of certain obligations. Real estate owned and mortgaged by corporations organized for and engaged in the business of buying, selling and dealing in real estate, warehouse receipts representing property the subject of sale in the ordinary business of the corporations owning same, and which warehouse receipts are pledged as collateral for such corporations' own debt, are examples where the interest will be deductible without limit.[49] If a corporation whose ordinary business is the purchase and sale of real estate has an office building under mortgage, which office building is not subject to sale in the ordinary business of the corporation, the interest paid on such mortgage may not be deducted without limit.[50]

AS A DEALER ONLY. The only corporations which will be allowed under this proviso to deduct interest in full

48 T. D. 1993.
49 T. D. 2090.
50 T. D. 2137.

are those which are organized and operated for the purpose of buying, selling and dealing in the particular kind of property upon which the mortgage is given, and the particular property pledged for the debt upon which the interest is paid must be the subject of sale in the ordinary business of the corporation.[51]

ORDINARY BUSINESS OF THE CORPORATION. Where a corporation deals in the property serving as collateral for the indebtedness as a matter of its ordinary business, deduction may be made in full, but where the property is held by it for the purpose of, or as an instrument in carrying on, its ordinary business such as the rights of way and other property of public utility companies, permanent office buildings and property of like character held or occupied for the particular use or purpose or the furtherance of the objects of the corporation, the property is held not to be the subject of sale in its ordinary business, but to be occupied or used as an instrument of carrying on the ordinary business for the transaction of which the corporation is organized. The fact that such property may be subject to sale under extraordinary or peculiar conditions does not qualify it as collateral.[52]

Interest on Tax Free Bonds. Where a corporation has issued bonds or other indebtedness with a guarantee that the interest thereon shall be paid without deduction for any tax which the corporation may be called upon to pay or withhold under the laws of the United States or of any state or jurisdiction, it is not permitted to deduct as additional payment of interest (or as taxes)

[51] T. D. 1993.
[52] T. D. 1993.

any amount which it may be required to pay, pursuant to such guarantee, in addition to the regular interest.[53]

Taxes. A corporation may deduct all taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes) or its territories, or possessions, or any foreign country, or under the authority of any state, county, school district, or municipality, or other taxing subdivision of any state, not including those assessed against local benefits. This provision is identical with the provision allowing deduction of taxes to individuals. A general discussion of the limitations will be found in the subsequent chapter on deductions.[54]

Deduction of Dividends on Stock of Other Corporations. Under the 1913 Law corporations were not permitted to deduct from their net income the amount received as dividends from other corporations subject to the income tax. This is likewise true under the 1916 Law. For the purpose of the 1917 Law, dividends on the stock of such other corporations as are taxable thereunder on their net income may be deducted.[55] Thus, for the present year a corporation may not deduct dividends in computing the 2% tax imposed by the 1916 Law, but may do so in computing the 4% tax imposed by the 1917 Law. Dividends received from foreign corporations which pay no income tax to this Government may in no case be deducted.

Holding and Subsidiary Corporations. The fact that one corporation may hold the entire capital stock of

53 Act of September 8, 1916, § 12.
54 See Chapter 30.
55 Act of October 3, 1917, § 4.

another and that the two may be component parts of one business unit or system does not destroy the separate entities of the two corporations. Corporations as such are subject to the tax, not the business organizations of which the corporations may be a part. Every corporation is considered to be a distinct entity regardless of its relation to any other corporation. Where a parent corporation owns all or practically all of the stock of subsidiary companies, each must make a true and correct return accounting in detail for their separate gross incomes and deductions, and each is required to pay the tax on the net earnings shown by such return. The parent company is not permitted to report the gross income of all the subsidiaries and deduct therefrom the gross expenses. The net earnings of the subsidiary companies turned over to the parent company are to be treated as dividends, notwithstanding that the earnings out of which the dividends were paid are also subject to tax as against the subsidiary companies.[56] In a case under the 1909 Law it was held that although the affairs of the holding and operating company were closely connected and they had officers in common, the distinct corporate existence of each should not be ignored and the holding company should not be treated as being engaged in the business of the operating company.[57]

INACTIVE SUBSIDIARIES. The fact that a corporation has a number of subsidiaries only for the purpose of protecting trade brands, trade marks and trade names is immaterial. The liability to make separate returns attaches to each subsidiary company by reason of the fact that it is a separate and distinct entity. If such

[56] T. D. 2137; T. D. 2090.

[57] U. S. v. Nipissing Mines Co., 206 Fed. 431.

subsidiary has no net income or earnings and no expenses of operations, and if the earnings accrue direct to the parent company, which also pays direct the operating expenses of the subsidiaries, those facts should be set out in the return of the subsidiary, but they do not operate to release the subsidiary from liability to make a return.[58] Thus, subsidiaries must in all cases make returns although they may have no income and be subject to no tax.

LEGAL TITLE TO EARNINGS OF SUBSIDIARIES. Where a subsidiary company kept no bank account, but its earnings were deposited in the bank account of the parent company which advanced the necessary funds whenever needed by the subsidiary for any operating expenses, or for additions or betterments, it was held that the actual possession of the moneys did not give the parent company a legal title. The annual earnings of the subsidiary were declared as dividends and at that time the dividends were income to the holding company.[59]

TAXABILITY OF HOLDING COMPANIES ON BOOKKEEPING CREDITS. The Treasury Department has held that in a case wherein a holding company actually takes up each month on its books its proportionate share of the earnings of the underlying companies, such holding company will be required to include in its gross income the amounts thus taken up regardless of the fact that the same may not have been actually paid to it in cash. The fact that the underlying companies credit to the holding company the amount of the earnings to which

58 T. D. 2161.

59 Southern Pacific Company v. Lowe, 238 Fed. 847.

it is entitled on the basis of the stock it holds, together with the fact that the holding company takes up on its books the amount thus credited, renders it incumbent upon the holding company to return these amounts as income, regardless of the fact that the underlying companies needed the earnings and actually used them in making extensions and improvements and in furtherance of their business.[60]

GIFTS TO SUBSIDIARIES. In cases where holding companies have made "gifts" to their subsidiaries to make up a deficit at the end of the accounting period of the subsidiary it has been held by the Treasury Department that such "gifts" were not a proper deduction from the net income of the holding company and were not exempt when received by the subsidiary. This ruling was supported by the provision of the 1913 Law relating to the exemption of gifts, but seems to have no application to the 1916 Law in which the provision as to exemption is much broader. The 1913 Law allowed gifts to be deducted from the net income of individuals while the present law includes gifts among the other classes of income which are exempt from the law, such as interest on state, national and municipal bonds, etc.[61]

Lessor and Lessee Corporations. The fact that a corporation may have leased all of its property to another under a contract whereby the lessee corporation pays the rent direct to the stockholders and bondholders of the

60 T. D. 2137. This ruling does not seem to be in accordance with the rule frequently announced by the courts that mere bookkeeping entries do not constitute income.

61 Compare Act of October 3, 1913, ¶ B, and Act of September 8, 1916, § 4.

lessor does not operate to relieve the lessor corporation of liability to the tax on the rental which the lessee pays to such stockholders. Where under the terms of a lease a lessee agreed to pay the interest upon and discharge the bonds issued by the lessor, to maintain the right of way and buildings, and to pay direct to each stockholder of the lessor dividends at the rate of eight per cent. per annum, it was held that the amounts paid to the creditors and stockholders of the lessor were rents or compensation to the lessor for the use and occupation of its property and constituted net income to it. It was held to be immaterial that the dividends paid to the stockholders of the lessor were fixed as to amount by the lease and paid direct to such stockholders. It was also held to be immaterial that the lessor was not possessed of money or other cash revenues with which to pay the tax. The lessor could not exonerate itself from liability for the tax subsequently imposed under a law thereafter enacted by making a lease of its property which provided for the payment of all its surplus revenues direct to its stockholders.[62] The notion that a corporation is an artificial entity distinct from the members who compose it is a fiction of the law which the courts recognize for some purposes and disregard for others. Thus the fact that a lessee corporation pays the rent not to the lessor corporation but to its stockholders and bondholders, cannot prevent the lessor corporation from being taxable.[63]

LESSEE CORPORATIONS. A railroad company operating leased or purchased lines is required to include all re-

62 Rensselaer & Saratoga Railroad Company v. Irwin, 239 Fed. 739; Reg. 33, Art. 80; T. D. 2090.

63 Anderson v. Morris & Essex Railroad Company, 216 Fed. 83.

ceipts derived therefrom, and if the bonded indebtedness of such lines has been assumed the operating company may deduct the interest paid thereon to the extent of the limit allowed by law. Corporations operating leased lines should not include the capital stock of the lessor corporations in their own statement of capital stock outstanding at the close of the year. The indebtedness of the lessor corporation should not be included in the statement of the indebtedness of the lessee unless the lessee has assumed the same.[64]

LESSOR CORPORATIONS. A corporation which has leased its properties in consideration of a rental equivalent to a certain rate of dividends on its outstanding capital stock and the interest on bonded indebtedness, and such rental is paid by the lessee direct to the stock and bondholders, should, nevertheless, make a return showing the rental so paid as having been received by the corporation.[65]

TREATMENT OF INCOME BY STOCKHOLDERS OF LESSOR. Where the lessor corporation is required to report as its own income the amount paid to its stockholders and bondholders by the lessee the stockholders should treat the amounts received from the lessee as dividends on the stock by which they hold in the lessor company. In paying direct to the stockholders the lessee is held to be acting as the agent of the lessor and the amounts received by the stockholders are in effect and in fact dividends received out of the earnings of the lessor and consequently not subject to the normal tax.[66] Similarly

64 Reg. 33, Art. 82.
65 Reg. 33, Art. 80.
66 T. D. 2090.

bondholders of the lessor company should treat the amounts received from the lessee as interest upon the indebtedness of the lessor.

Receivers for Corporations. The 1916 Law provides that in cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of a corporation such receivers, trustees, or assignees shall made returns of net income as and for such corporation in the same manner and form as is required in the case of corporations generally. Any income tax due on the basis of such returns made by receivers, trustees or assignees shall be assessed and collected in the same manner as if assessed directly against the corporation.[67] Receivers of corporations are not fiduciaries within the meaning of the law and are not governed by the same rules as are made applicable to receivers for individuals. The receiver of a corporation stands in the same position as the officers of a solvent corporation and upon him devolve all the duties of such officers as to the making of returns and payment of tax. The fact that the business and property of the corporation are temporarily in the hands of a receiver does not alter the fact that the corporation is none the less the beneficiary of the income arising and accruing. If there is net income it is taxable, and the custodian of such income is liable for the tax assessable thereon. Under the 1913 Law, as well as under the 1909 Law, there was no express provision in the statute taxing corporations in the hands of receivers. Several cases under the 1909 Law held that that act did not impose a tax on such corporations or any duties on the receivers thereof. The 1909 Law was a tax on corporations doing business and it was held in

[67] Act of September 8, 1916, § 13, ¶ (c).

several cases that a corporation in the hands of receivers was not one doing business within the meaning of those words as used in that act. Only one decision seems to have been rendered under the 1913 Law and in that case it was held that receivers were not subject to the income tax where the court took possession of the property of an insolvent railroad company and operated the railroad. The funds in the hands of the receivers, represented by the net proceeds in conducting the operation of the road, over and above the authorized expenditures paid out by them, were held not to be subject to the tax as "net earnings."[68] The question is no longer open under the express provisions of the 1916 Law.

Fiscal Year. Corporations are required to make reports and pay the tax for the calendar year unless they have duly designated a fiscal year in which case the

[68] Equitable Trust Company v. Western Pacific Railway Company, et al., 236 Fed. 813. This case was decided on the authority of Pennsylvania Steel Company v. New York City Railway Company, in which case the question came up two successive times in the District Court and once on appeal in the Circuit Court of Appeals.

On appeal by the Government, the Circuit Court of Appeals in affirming the lower court held, First, that the taxation of business done and income received by receivers was not contemplated by the Act, receivers not being mentioned; Second, there can be no doubt that the tax provided for by the Act was imposed as a tax upon doing business in a corporate capacity; Third, the Act in all its provisions clearly contemplated the tax was to be paid by a corporation which was actually engaged in business as an actively operating concern; Fourth, it was manifest that the functions of the company, as a corporation, were superseded when all its property was placed in the hands of receivers by a court of equity in order that it might be saved for the benefit of all its creditors. (198 Fed. 774; 117 C. C. A. 556.)

returns may be made and the tax may be paid upon the basis of such fiscal year. The privilege of making a return of income on the basis of the fiscal year is limited to corporations.[69]

Requirements as to Fiscal Year. The fiscal year must be a period of twelve months. It cannot exceed that length of time. In case a corporation designates a fiscal year ending on a date more than twelve months subsequent to the last day of the calendar year or fiscal year for which it made its last report, two reports are required within that period; the first report to cover that period of time from the last day of its former accounting period up to the day twelve months prior to the ending of the new fiscal year. The fiscal year must end upon the last day of some calendar month, as expressly provided in the law.[70] No return rendered for a period ending on any date other than the last day of some month will be accepted unless it is a "final return" and made to the day the corporation ceased business.[71] In the case where a corporation designates the calendar year as its fiscal year no notice or formality is required; where the fiscal year ends upon the last day of some month other than December, notice of the adoption of such fiscal year must be duly filed with the local collector.

How Designated. The fiscal year may be designated by giving notice of the day which has been chosen as the closing of the fiscal year to the collector of the district in which the corporation files its return at any time not less than thirty days prior to the first day of March of the year in which its return would be filed if made upon

69 T. D. 2090.

70 Act of September 8, 1916, § 13, ¶ a.

71 Mimeograph letter to Collectors No. 1148.

the basis of the calendar year. Thus, for instance, a corporation at present reporting for the calendar year may adopt a fiscal year by giving notice to the collector at any time not less than thirty days prior to March 1 of the year following. Thereafter, on or before March 1, it will file a return of net income for the period beginning January 1 of the preceding year and ending the day preceding the first day of the new fiscal year, unless such period is more than twelve months, in which case a return is required for the preceding calendar year and another return for the part of the following year up to the beginning of the fiscal period. That portion of the year preceding the beginning of an established fiscal year is held to be a fractional portion of the calendar year and the return therefor is not required to be filed before March 1st of the year following, but it may be filed at any time after the closing of the period.[72] A return for the fiscal year will not be accepted unless such fiscal year has been properly established according to the law and the rulings of the Treasury Department.[73] If due notice has not been filed with the collector at least thirty days prior to March 1, a return for the preceding calendar year must be filed although the corporation has in fact established its accounting period on the basis of a fiscal year, other than such calendar year.

New Corporations. The rulings as to fiscal year apply to corporations which begin business within the year, as well as to those which were in existence and transacted business throughout the year. In the case of a new corporation the first return may be made for a

72 T. D. 2029.

73 Mimeograph letter to Collectors No. 1148, I. T. S. 1917, ¶ 1532.

fiscal year if it has duly filed a notice designating the same, provided the period intervening between the date of the organization and the close of the fiscal year does not exceed twelve months. If such period exceeds twelve months, the corporation will be required to make a return for the portion of the calendar year preceding the beginning of the fiscal year, which return must be filed on or before March 1st next following the calendar year of which it is a part. Corporations partially organized are required to file a return for the period ending December 31, unless they have established a fiscal year for this purpose.[74]

NOTICE. The notice must be in writing, setting forth that the corporation has designated the last day of some month in the year (other than the last day of December) as the day of the closing of its fiscal year, and that from the date so designated its books have been or will be kept on the basis of such designated fiscal year.[75] The notice should be signed by the president or other principal officer of the corporation or by the treasurer, that is, by at least one of the officers required to sign the return of annual net income and preferably by both of them. It may be given in the form of a letter addressed to the local collector and may be filed at any time after the fiscal year has been established.

CHANGING FROM FISCAL YEAR TO CALENDAR YEAR. A corporation which has adopted a fiscal year and thereafter desires to change from the fiscal year back to the calendar year may do so by designating the calendar year as its new fiscal year, and filing a notice accordingly.

74 T. D. 2001; T. D. 2137.
75 T. D. 2090.

Return of Annual Net Income. The duty to make a return depends upon the corporate existence and not upon the receipt of income. Every corporation not specifically enumerated as exempt is required to make a return whether or not it has any income liable to tax [76] or whether or not it is subordinate to or controlled by another corporation.

WHEN FILED. Unless a corporation has duly designated a fiscal year, the return must report the net income received within the preceding calendar year and must be filed on or before the 1st day of March of the year following. If it has duly designated a fiscal year, the return may be filed within sixty days after the close of such fiscal year.[77] The time for filing returns may be extended as stated in the chapter containing the general provisions relating to returns.

WHERE FILED. The return should be filed with the collector of the district in which is located the principal office of the corporation where are kept its books of account and other data from which the return is prepared. If a domestic corporation keeps its books of account and other data in a foreign country, the return should be made to the collector of internal revenue in the district in which the company has its branch office in this coun-

[76] Reg. 33, Art. 80; T. D. 2090. Under the 1909 Law it was held that corporations of all kinds specified in the Act as subject to the tax were bound to file returns though their net profits were not sufficient to render them liable to the tax (U. S. v. Military Construction Co., 204 Fed. 153,) and that the duty to make returns was not limited to those the net profits of which were sufficient to render them liable to the payment of the tax. (U. S. v. Acorn Roofing Co., 204 Fed. 157.)

[77] Act of September 8, 1916, § 13 (b).

try, if it has such branch office; otherwise it should be made in the district in which is located the statutory office of the corporation, that is the office required to be maintained in the state of incorporation in accordance with the statutes of that state.[78] It is to be noted that the return is not to be filed in the district in which is located the statutory office unless the corporation has no principal business office or branch office from which the return can be filed. The purpose of designating the principal business office is for the convenience of the Treasury Department in examining the books of the corporation and verifying the return. Since the statute now expressly designates the principal business office and describes it as the place where the books of account are kept, the filing of a return from another office may not be considered as a proper filing. The 1913 Law was less explicit and might have been held to justify the filing of the return from some other office but the 1916 Law is open to no such construction. Subsidiary companies are required to file their returns in the district in which they have their principal accounting office. regardless of where the parent company may make its return. If, however, subsidiary companies do not keep separate books of account they will be required to file their returns in the same district as the parent company. but will nevertheless be required to make separate returns.[79] Parent companies are required to file with their returns a list of all subsidiaries, with the location of the principal place of business of each.

By Whom Filed. The responsibility for filing the annual return rests, of course, upon the principal officers

78 T. D. 2137.
79 T. D. 2137.

of the corporation, although there is no penalty on such officers personally, for failure to file returns. The only personal penalty on officers is for making a false or fraudulent return. In the case of corporations in the hands of receivers, the return is made by the receiver and in the case of dissolved corporations it is made by the directors or other persons in charge of the winding up of the corporation. Under the Corporation Act of New Jersey, which provides that corporations however dissolved are "continued bodies corporate for the purpose of prosecuting and defending suits by or against them and of enabling them to settle and close their affairs," and constitutes the directors trustees to settle the business, the officers of a corporation which had been dissolved after becoming subject to the tax on its income of the preceding year, who were also its directors, were held to have authority and to be under the duty of making the return of such business required by the 1909 Law.[80]

How Prepared. All questions on the returns should be answered either by the insertion of figures or the insertion of the word "none." In answer to question No. 1 the corporation should state the total par value of its stock, both common and preferred outstanding at the close of the year. Stock outstanding at the close of the year and upon the basis of which dividends are or may be paid, is held to be paid up capital stock within the meaning of the law. For this purpose it is immaterial whether the stock be paid for in cash, promissory notes or other assets. The fact that notes are given in payment of stock issued and that the notes have not been paid in

[80] U. S. v. General Inspection & Loading Co., 192 Fed. 223.

full at the time the return is made is immaterial.[81] The unissued or treasury stock should not be included, but only such stock as has been actually issued and is outstanding at the close of the year, for which payment has been received. Where the stock issued is payable in instalments or assessments, only so much of it as has been actually paid in instalments and assessments should be reported. In case no stock is issued, there should be reported the amount of capital, not including interest-bearing indebtedness, actually employed in the business and property of the company at the close of the year.

BONDED AND OTHER INDEBTEDNESS. Indebtedness to be included under item 2 of the return is all interest-bearing indebtedness except that wholly secured by collateral the subject of sale in the ordinary business of the corporation. The amount outstanding at the close of the year should be reported whether the interest accrued upon such indebtedness was actually paid within the year or not.[82]

SUPPLEMENTARY STATEMENT. The supplementary statement must be filled out in detail and no return which is not substantially correct in this respect will be accepted.[83] However, the division indicated in the supplementary statement on the corporation forms has been said by the Treasury Department to be merely suggestive. It desires information so far as possible in detail as to what items go to make up the general expense and if this information is sufficiently given in detail in a statement filed by the corporation with the Public Service Com-

81 T. D. 2137.
82 T. D. 2137.
83 Mimeograph letter to Collectors No. 1148.

mission of its state the Treasury Department has no objection to such statement being attached to the return in lieu of filling out the supplementary statement.[84] If the books of any corporation are kept in such manner as to make it very difficult to give the information in the exact form called for in the supplementary statement a reasonble explanation in detail of the manner of arriving at gross income and expenses will be accepted. However the information should be furnished in such manner that the returns can be intelligently audited by the Government.[85]

INCOME FROM STATE, NATIONAL OR MUNICIPAL BONDS. Although a corporation is not subject to tax on interest received from state, national or municipal bonds, as such income is exempt, the Treasury Department requires the corporation to report the interest received from such bonds in the supplementary statement on the back of the annual return. This is required under the provision of the law which calls for returns by corporations in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, may prescribe. If a corporation fails to report this species of income it will be held by the Treasury Department to not have fully complied with the requirements of the law and to have failed to make a true and correct return such as the law, the regulations and the prescribed forms require. There is no specific provision of the law whereby a corporation is required to list its holdings of such bonds, but the regulations of the department and the

[84] Letter from Treasury Department dated January 6, 1915; I. T. S. 1917, ¶ 1589.

[85] Letter from Treasury Department dated January 29, 1915; I. T. S. 1917, ¶ 1595.

form itself, which have the force and effect of law, do require it and the requirements should be complied with.[86]

How Signed and Sworn To. The return is required to be sworn to by the president, vice-president or other principal officer of the corporation and by the treasurer or assistant treasurer, and must be verified under the oath of such officers, except in the cases where the return is filed by a receiver, trustee or assignee, or directors in the case of insolvency, in which cases the affidavit on the return should be changed in accordance with the facts. As to the general provisions respecting the oath or affirmation see the chapter on reports.[87]

Special Returns by Corporations. In addition to the return of annual net income required to be filed by every corporation several special returns are required annually or at such times as the Commissioner of Internal Revenue may request.

Report of Dividend Payments. Every corporation, when called upon by the Commissioner of Internal Revenue, is required to render a correct return, duly verified under oath, of its payments of dividends, whether made in cash or stock, including the names and addresses of stockholders and the number of shares owned by each, and the tax years and the applicable amounts in which such dividends were earned, in such form and manner as may be prescribed by the Treasury Department. This return is for the purpose of supplying the

86 Letter from Treasury Department dated March 6, 1916; I. T. S. 1917, ¶ 1598.

87 See Chapter 35.

Government with information against which the annual returns of stockholders may be compared, and is more fully covered in the chapter on Information at the Source.[88]

REPORT OF INCOME PAYMENTS. All corporations in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees, executors, administrators, receivers, conservators, and employers, making payment to any person, corporation or partnership of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable gains profits and income (other than dividends and the payments described in the following section) of $800 or more in any taxable year, are required to make returns in regard thereto to the Commissioner of Internal Revenue under regulations of the Treasury Department, setting forth the amount of payments and the names and addresses of the recipients. In the case of payments of interest upon its bonds, mortgages or deeds or trust or similar obligations, such return is required from the corporation regardless of the amount paid. This return is for the purpose of supplying the Treasury Department with information to be used in auditing the returns of the taxpayers to whom the income is paid, and is more fully discussed in the chapter on Information at the Source.[89]

REPORTS BY BROKERS. Every corporation doing business as a broker on any exchange or board of trade or similar place of business is required, when called upon by the Commissioner of Internal Revenue, to make a

88 See Chapter 40.

89 Id.

return showing the names of customers with such details as to profits, losses or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner of Internal Revenue to determine whether all income tax due on profits or gains of such customers has been paid. This report is for the purpose of information at the source and is more fully covered in the chapter on that subject.[90]

SPECIAL REPORT OF UNDISTRIBUTED PROFITS AND NAMES OF SHAREHOLDERS. When a corporation has permitted its gains and profits to accumulate and become surplus to such an extent that the Secretary of the Treasury certifies that in his opinion such accumulation is unreasonable for the purpose of the business it may be required by the Commissioner of Internal Revenue or any collector to file a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.[91] This return is required under that provision of the 1916 Law which is intended to prevent the creation or use of corporations for the purpose of fraudulently preventing the imposition of the supertaxes, through the medium of permitting the gains and profits to accumulate instead of being divided or distributed. The fact that a corporation is a mere holding company or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business are *prima facie* evidence of a fraudulent purpose to escape such tax, but the Secretary of the Treasury must first certify that in his opinion such accumulation is unreasonable for the purposes of the business. When the accumulation has

90 See Chapter 40.

91 Act of September 8, 1916, § 3.

been so certified to be unreasonable the respective stockholders will be required to include in their personal returns the share of such profits to which they would be entitled if they were divided and distributed.

Withholding the Tax at the Source. No withholding takes place on payment of income to domestic corporations. Such corporations are required to withhold the tax on payments of fixed or determinable annual or periodical income to non-resident aliens, and on payments of bond interest and dividends to non-resident foreign corporations as indicated in the chapter on collection at the source.[92]

[92] See Chapter 41.

CHAPTER 13

SPECIAL PROVISIONS APPLYING TO INSURANCE COMPANIES

In the case of insurance companies, both domestic and foreign, certain special provisions govern the reporting of income and the making of deductions.[1] In general domestic insurance companies are subject to the same provisions as other domestic corporations and foreign insurance companies are subject to the same provisions as other foreign corporations. The foregoing chapter should be consulted as to the general provisions relating to corporations and the following chapter should be consulted as to the special provisions applicable to foreign corporations. Two special forms for making the return of annual net income are provided for insurance companies, one to be used by mutual insurance companies other than mutual life and mutual marine, and the other to be used by all other insurance companies including mutual life and mutual marine.

Gross Income. The gross income of insurance companies consists of the total revenue derived from the operation of the business including income, gains and profits from all other sources, except as modified by the express exemptions in the statute. The statements on the return of annual net income should conform with the reports of the same years made to the state insurance

1 Act of September 8, 1916, § 12.

departments. Reinsurance and return premiums should not be included in the gross income or deductions of an insurance company.

Expenses. The same allowance for expenses is permitted as in the case of other corporations. Insurance companies will be permitted to add to expenses, in lieu of depreciation of furniture and fixtures, the actual cost of repairs, replacements and renewals on such furniture, as is reported to the state insurance department, provided that in the case of an original investment, the cost thereof shall be charged to the capital account.

Deduction of Net Addition to Reserve Funds. In the case of all insurance companies, the net addition, if any, required by law to be made within the year to reserve funds may be deducted. The net addition may be based upon the highest authorized reserve required by the statutes of any state in which the company does business, but having adopted the requirements of one state the company cannot base its reserve upon the requirements of another state for subsequent years.[2] Legal reserve funds are those sums required by state laws to be maintained by an insurance company to secure its liabilities upon policies written. They are accumulated out of the income of the company and are in reality simply its invested assets, approved securities sufficient in amount to meet its liabilities. This reserve is not intended to cover the company's liability with respect to the insurance written, but is a fund providing against loss in case the company should go out of business. It does not secure all the creditors or claimants of the company. The computation of the amount is ascertained upon a

[2] T. D. 1727.

hypothetical basis, and the rules governing it are arbitrary. The laws of the states, probably without exception, require the maintenance of this reserve and the insurance companies for years have recognized the wisdom of its existence.

Loss and unpaid liability claims afford an exact basis for computation, and the reserves maintained cover the liability therefor. The state statutes most generally require the maintenance of a reserve to cover each class of this particular kind of insurance, but an insurance company cannot expand this privileged deduction to include all liabilities. Unpaid taxes, unpaid salaries, brokerage, and agents' commissions are current expenses; they are essential items of expense in the daily, monthly, and yearly conduct of the company's business; the amount and date of payment is fixed and determined; they depend for liquidation solely upon the company's earning capacity as the business progresses. Apparently no state law requires the maintenance of a reserve to secure these payments. A permanent reserve for taxes is not necessary or required by law, and they are not properly included in the net additions required by law to reserve funds. The income tax law specifically limits the deductions to sums required by law, not such reservations as business prudence may suggest, and the express provisions of the law fix the determining basis.[3]

RESERVES REQUIRED BY LAW. Only those reserves which are "required by law" may be deducted. Under the laws of Pennsylvania reserves against unpaid losses are required by law of casualty companies, but not of fire and marine insurance companies. Hence, the latter cannot deduct reserves against losses, although the In-

3 Maryland Casualty Co. v. U. S., Court of Claims, T. D. 2451.

surance Commissioner of Pennsylvania may require such reserves under a practice of his office established for many years and relied upon as an administrative interpretation of the law of that state.[4]

Released Reserves. Where there has been a decrease in reserve funds the amount of the decrease is commonly called released reserve, and is to be treated as income for the year in which the reserve is released. Released reserves though not mentioned in express terms in the law have been held to be income and taxable for the year in which released.[5]

Assessment Insurance Companies. In the case of assessment insurance companies, whether domestic or foreign, the actual deposits of sums with state or territorial officers, pursuant to law, as additions to guaranty or reserve funds shall be treated as being payments required by law to reserve funds.[6]

Payments on Policies. All insurance companies may deduct the sums, other than dividends, paid within the year on policy and annuity contracts. Under this item on the return of annual net income may be included all death, disability or other policy claims, including fire, accident and liability losses, matured endowments, payments on instalment policies, surrender values and all claims actually paid under the terms of policy contracts. In the case of life insurance companies amounts paid as

4 McCoach v. Insurance Company of North America, 228 U. S. 295.

5 Maryland Casualty Company v. U. S., Court of Claims, T. D. 2451.

6 Act of September 8, 1916, § 12, Subdiv. (c).

consideration for supplementary contracts, and applied surrender values, should be separately reported.[7]

Mutual Fire Insurance Companies. Companies of this character are required to report under a special provision of the 1916 Law which provides that such companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to the policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves. Under this provision the Treasury Department has prescribed a special form for such companies.[8]

Capital Employed in Business. The capital employed in business by such companies is held to be the capital invested in real estate and other assets.

Indebtedness. The interest-bearing indebtedness of such companies is required to be reported. The amount should include all such indebtedness for the payment of which the company or its property is bound, but not indebtedness wholly secured by collateral the subject of sale or hypothecation in the ordinary business of the company.

Premiums. The amount to be reported as premiums includes the net amount received from the policyholders after deducting therefrom the premiums returned and

7 Instructions on Form 1030.

8 Form 1030A.

such portion of the premiums as is retained for the payment of losses, expenses and reinsurance reserves. Only that part of the premiums retained for any other purpose is taxable income and should be returned as such.

PROFIT ON SALE OR MATURITY OF LEDGER ASSETS. The profit or income to be returned in the event of sale or maturity of capital assets should be determined in the same manner as in the case of other corporations. The profit or income may, for the purpose of the tax, be reduced by the amount of any loss resulting from the same source and ascertained in the same manner. In no event can a loss resulting from the sale or maturity of capital assets exceed the profit within the year from like transactions.

RENTALS. Rentals to be reported as income include the net amount of all payments received in cash or its equivalent, as rent on buildings or other property owned or controlled by the company making the return, after deducting rents paid by the company and also such amounts of repairs and expenses, including taxes, as have been expended on the property from which the rental income reported was derived.

INTEREST ON BONDS. The interest received on bonds to be reported as income does not include interest exempt from tax under the 1916 Law.

COMMISSIONS ON REINSURANCE. Commissions received for reinsurance to be reported as income should be the net amount after deducting the amount of reinsurance commissions actually paid within the year.

DEDUCTIONS. No deductions are permitted to be made from the amount of income reported by mutual fire insurance companies. The amount of premiums, assessments, fees, etc., reported as income is such an amount as is retained for purposes other than the payment of losses, expenses and reinsurance reserves hence the expenses of doing business of the company are deducted from the amount of such premiums before the sum is reported in the return. Similarly the amount received as rent on buildings owned by such companies is the net amount after deducting rentals paid by the company on buildings which it may occupy as a tenant, taxes paid by the company on buildings which it owns, and repairs and expenses incident to the operation of buildings which it owns. Thus it will be seen that the report for mutual insurance companies is a report of net income in the true sense of the word, the gross income not being reported except so far as is required for purposes of information in the supplementary statement on the back of the return.

Mutual Employers' Liability Insurance Companies. The 1916 Law included companies of this class in the same class as mutual fire insurance companies and the statement in the preceding paragraphs regarding such companies applies equally to this class of companies.

Mutual Workmen's Compensation Companies. The 1916 Law included companies of this class in the same class as mutual fire insurance companies and the statement in the preceding paragraphs regarding such companies applies equally to this class of companies.

Mutual Casualty Insurance Companies. The 1916 Law included companies of this class in the same class

as mutual fire insurance companies and the statement in the preceding paragraphs regarding such companies applies equally to this class of companies.

Mutual Marine Insurance Companies. Mutual marine insurance companies are required to include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but are entitled to include in the deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with interest upon such amounts between the ascertainment thereof and the payment thereof.[9] In other respects the companies of this class proceed in the same manner as insurance companies generally.

Life Insurance Companies. Life insurance companies, including stock and mutual companies, do not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder or treated as an abatement of premium within the year.[10] In so far as "deferred dividends" payable at a stated period represent "a portion of any actual premium received," they may be omitted from gross income for the year in which they were actually paid back, except that so much of any deferred dividends

9 Act of September 8, 1916, § 12; Reg. 33, Art. 99.

10 Under the 1909 Law there was much litigation as to whether so-called dividends paid by insurance companies to policyholders as a return of a part of the premium were properly deductible. The courts held that the so-called dividends awarded annually to policyholders did not constitute income (Herold v. Mutual Benefit Life Insurance Company, 201 Fed. 918) and at the time of the enactment of the 1913 Law the point was expressly covered by the same language as in the present law.

paid during the tax year to the individual policyholder as exceeds the amount of premiums paid during the same year may not be omitted. Only the actual amount of dividends actually credited or apportioned to a policyholder during the premium-paying period, and not any accretions thereto, can be excluded from gross income. In the cases of whole life or five-year distribution policies, deferred dividends may be excluded from gross income to the extent that they are paid back or credited to the insured or used as an abatement of annual premiums.[11]

SUPPLEMENTARY POLICY CONTRACTS. Where a life insurance company's policies contain an option to have proceeds paid in annual instalments for a given term of years, or during the lifetime of the beneficiary, instead of in one sum, such policies, if the option is exercised, are styled "supplementary policy contracts." These obligations are protected by reserves, the net additions to which are deductible if such reserves are "required by law." The Commissioners of Insurance of all the states require the establishment of a reserve to cover the obligations of the company on such supplementary policy contracts. This fact of itself tends strongly to show that they are required by law,[12] but if the action of a commissioner of insurance is based in such cases upon the practice of his office and not upon an express requirement of law, deduction may not be made.[13]

PAYMENTS ON POLICIES. Surrender values applied in any manner, consideration for supplementary policy con-

11 Reg. 33, Art. 100.

12 Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199.

13 See Maryland Casualty Co. v. U. S., Court of Claims, T. D. 2451.

tracts, involving and not involving life contingencies, should be included in the income of life insurance companies. Applied surrender values and consideration for supplementary contracts not involving life contingencies included in income are deductible as payments under policy contracts, but for convenience in verifying the returns these items should appear in the return in both gross income and deductions.[14]

Mutual Life Insurance Companies. Mutual life insurance companies file the same return as stock companies and are governed by same rules with respect to computing net income.

14 Reg. 33, Arts. 101 and 102.

CHAPTER 14

FOREIGN CORPORATIONS

The 1916 Law provides that the income tax shall be assessed and collected annually upon the total net income received by every corporation, organized, authorized or existing under the laws of a foreign country, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, and including the income derived from dividends of corporations whose net income is taxable under the law.[1] The deductions permitted to foreign corporations are in general the same as those permitted to domestic corporations but specifically limited to the business or property in this country. This chapter deals with the special provisions applicable to foreign corporations. The chapter on domestic corporations should be referred to for provisions which have general application to all corporations.

[1] Act of September 8, 1916, § 10. Under the 1913 Law foreign corporations were taxable only upon the income accruing from business transacted and capital invested within the United States. Interest and dividends received by foreign corporations were held to be income from capital invested in this country, although at first it was held under that law that interest and dividends received by non-resident alien individuals were not subject to tax, but after the decision in the case of Brushaber v. Union Pacific Railway Company, 240 U. S. 1, the Treasury Department changed its rulings and held that interest and dividends so received were subject to the tax, whether the recipient was an individual or a corporation. (T. D. 2313.)

Corporations Exempt from the Tax. The corporations enumerated in the law as exempt include foreign corporations as well as domestic corporations, except as stated in the chapter on exempt corporations.[2]

Corporations Subject to the Tax. All foreign corporations deriving income from sources within this country and not specifically exempt as indicated above are subject to the tax.

Sale of Goods by Correspondence. Where a foreign corporation sells goods in this country by correspondence, or delivers goods so sold to a citizen or resident of this country, no attempt is made to impose the tax on such transactions. The conclusion seems to be that such sales do not create any income from sources within the United States. This seems to be true in all cases where the contract for the sale of goods is made in a foreign jurisdiction whether the title to the goods passes in the foreign jurisdiction or title is retained after the goods arrive in this country until payment therefor has been made. Where, however, a resident of this country pays interest on any deferred payments of purchase price the interest is clearly subject to tax under the express provisions of the law.

Traveling Salesmen. The Treasury Department has held as follows: Where a foreign corporation sends a representative to this country to solicit business, the merchandise thus sold to be shipped direct to the consignee, the corporation is transacting business in this country. The fact that the solicitor or representative has only a mailing address in this country is immaterial, as

[2] See Chapter 15.

he is none the less an agent of the foreign corporation. To the extent that he sells in this country goods or merchandise for the foreign corporation, to that extent the foreign corporation is transacting business in the United States and is required to make a return to the collector in the district in which its representative has his mailing address.[3] An agent who is doing business in this country, buying and selling certain products of the foreign corporation, is to all intents and purposes a branch of the foreign corporation as through and by him the foreign corporation is transacting business here. The buying and selling of products in this country through a local agency or branch is clearly transacting business here.[4] Under the 1913 Law it was held that a foreign corporation was subject to the tax on income accruing from business transacted and capital invested within the United States, where (a) it sent agents into the United States to solicit purchasers for its products, hiring desk room in the United States and empowering the salesmen to make written contracts, (b) shipped its product consigned to itself in the United States to different points where it hired storage rooms and stored the product in its own name and at its own risk to insure delivery according to contract, and to meet anticipated demands.[5]

[3] T. D. 2161.

[4] T. D. 2137.

[5] Laurentide Co. Ltd. v. Durey, 231 Fed. 223. The court said in part: "I think it would be somewhat difficult for the Laurentide Co., Ltd., or its able attorney, to describe what it was doing in the United States, if it was not doing, carrying on and transacting business therein, when there receiving large quantities of newspaper, consigned to itself and storing it, hiring and paying for storage room therefor, delivering it to customers, purchasers thereof, soliciting contract by agents for the purchase and supply

Foreign Steamship Companies. Foreign steamship companies engaged in the business of transporting passengers, goods and merchandise between ports in this country and foreign ports and maintaining passenger and freight agencies in this country, are doing business here and subject to the income tax. There seems to be no question of constitutionality involved in such tax being a tax on exports.[6] A firm in Great Britain chartered its vessels (tramp steamers) to residents of the United States who operated them from ports in this country. It was held by the Treasury Department that the net income accruing to the foreign firm as a result of this transaction was income derived from capital invested and business transacted in the United States, on the ground that steamers chartered to parties in the United States occupied the same position for the purpose of the income tax law as do branches of foreign corporations located in the United States.[7] Foreign steamship companies

of same, renting and paying rent for a room for doing the business, depositing and collecting the checks received in payment and paying the expense of the business therefrom, all done in the State of New York in the United States. It was not necessary that the contracts should have been made wholly in the United States, or that their execution or performance should have been wholly in the United States.'' Under the 1909 Law it was held that where the foreign corporation owned timberlands in this country and operated a match factory but sold its lands and plant, payments to be made in instalments, the foreign company to retain the title until paid in full, it was not doing business, although retaining an attorney in the state to look after its interest and an agent for service of process as required by state statute. (Bryant and May, Limited, v. Scott, 226 Fed. 875.) Under the same state of facts the corporation would be taxable under the present law.

6 28 Op. Atty. Gen. 211; Aguirre v. Maxwell, 3 Blatch. 140.

7 Letter from Treasury Department dated December 8, 1916.

having no office in the United States, whose vessels only occasionally touch at ports in the United States, were not regarded as doing business in this country within the meaning of the 1909 Law,[8] but the point has not been ruled upon under the 1916 Law.

Foreign Governments. Under the 1916 Law, prior to the amendment of October 3, 1917, it was held by the Treasury Department that the income accruing to a foreign government from sources within the United States arising from interest on bonds or dividends on stock of domestic corporations was subject to tax. The law now provides that nothing in the 1913 Law or the 1916 Law shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from the interest on deposits in banks in the United States of moneys belonging to foreign governments.[9]

Resident Alien Corporations. A resident alien corporation is a foreign corporation having an office or place of business in the United States.[10] Such corporations, being within the jurisdiction of the United States, are required to file returns in the same manner as domestic corporations, disclosing their net income from sources within the United States, but are allowed only the deductions and exemptions permitted to foreign corporations. No withholding of the tax at the source takes place against such corporations.[11] Being taxable under the law the dividends of such corporations are corres-

8 T. D. 1675.

9 T. D. 2425; Act of September 8, 1916, as amended by Act of October 3, 1917, § 30.

10 T. D. 2401.

11 Reg. 33, Art. 46.

pondingly exempt to the same extent as dividends of domestic corporations. Interest on the obligations of such corporations would seem to be taxable in the hands of non-resident aliens and subject to deduction of the tax when paid to non-resident foreign partnerships or corporations.[12] The term "resident foreign corporations" is used in this book to indicate corporations of this class.

Non-Resident Alien Corporations. The term "non-resident alien corporations" covers all corporations organized, authorized or existing under the laws of a foreign country and having no office or place of business in the United States.[13] Such corporations are subject to the tax on all income from sources within the United States, and are required to file annual returns disclosing such income. Since such corporations are outside of the jurisdiction of this country, the act provides expressly that the tax on income from interest on bonds and dividends on stock of resident corporations shall be withheld at the source before the income leaves this jurisdiction. Provision is also made for collection of the tax by impressing a duty upon those in this country who have control, custody, receipt or disposal of the income of such corporations, as indicated in the following paragraphs. The term "non-resident foreign corporations" is used in this book to indicate corporations of this class.

Collection of the Tax at the Source. In the case of non-resident alien corporations as defined above, the

12 Act of September 8, 1916, § 1 and § 13 (e) as amended. Residence within the meaning of these provisions will probably be held to cover only cases where the principal business of the foreign corporation is transacted in this country, and payment of the interest is made here.

13 T. D. 2401.

normal tax is withheld at the source on all interest upon the bonds and mortgages or deeds of trust or similar obligations of resident corporations and upon all dividends upon the capital stock or from the net earnings of resident corporations. Such corporations cannot by filing any certificate or claim for exemption prevent the withholding of such tax, but may upon the filing of an annual return, which must include the amount of income on which the tax has been so withheld, claim a deduction of the amount so withheld and if the return discloses the fact that more tax has been withheld than is assessable against the corporation, the Treasury Department will order a refund of the excess amount withheld. For this purpose the return of the foreign corporation should have attached thereto a statement giving the names of the withholding agents and the amounts withheld respectively. For a further discussion of collection at the source see the chapter on that subject. There is no collection of the tax at the source on payments other than those described above, and in no case on payments made to resident alien corporations.

Nominal Stockholders. Where stock of domestic corporations stands in the name of nominal stockholders and the actual owners are non-resident foreign corporations, that fact must be disclosed. In cases where such corporations are nominal stockholders, withholding of the tax may be avoided by disclosing the actual owners. This subject is discussed in a preceding chapter.[14]

Resident Agents for Foreign Corporations. In addition to the provisions prescribed by the law for collection of the tax at the source on bond interest and dividends

[14] See Chapter 7.

paid to non-resident foreign corporations, the Treasury Department has evolved a method of collecting the tax by impressing upon residents of this country, under certain circumstances, the duty of filing returns and accounting for the tax due from foreign corporations on the income which passes through their hands. A general discussion of the duties of such agents and their relation to the foreign-corporation principal is contained in a preceding chapter on Resident Agents for Non-resident Aliens and Foreign Corporations.[15]

Income Subject to Tax. The gross income of foreign corporations is all taxable income received from all sources within the United States, whether or not the corporation does business in this country or receives income from investments of any kind. From the amount of such gross income may be subtracted the sum of the deductions enumerated in the act, which deductions are similar to those allowed to domestic corporations, but limited to expenses or allowances properly chargeable against the income from this country.

STEAMSHIP COMPANIES. Where a foreign steamship company has steamers which touch American ports and which carry therefrom freight and passengers the return should show as gross income the total receipts from all outgoing boats whether freight or passenger. With the gross income thus ascertained, the ratio existing between it and the gross income from all ports both within and without the United States should be determined as the basis upon which deductions may be computed.[16]

15 See Chapter 6.

16 Letter from Treasury Department dated July 18, 1916; I. T. S. 1917, ¶ 1114.

Foreign Corporations Having Branch Offices in This Country. Where a foreign corporation has one or more branch offices in this country the return should include the income of all the branches, including branches in the Philippines and Porto Rico. The principal branch office determines the district in which the return should be filed and the tax should be paid. Where branches in this country transact business in foreign jurisdictions, the net income accruing to the branch here, it seems that the income derived from such business in foreign jurisdictions should be treated as income from sources within this country since the management and conduct of such business is directed from within this jurisdiction and the foreign corporation eventually receives its net income from a source within this country, namely the branch conducting such business.

Income from Investments. Income from investments of all kinds in property located within this country is subject to the tax under the broad provisions of the law which provide for the taxation of the total net income from all sources within the United States.[17]

[17] Under the 1913 Law, the tax was imposed only upon such foreign corporations as were doing business *and* had capital invested in this country. The Treasury Department construed this to mean that the tax applied if a foreign corporation was either doing business *or* had capital invested here and held that money invested in the securities of American corporations was capital invested in the United States regardless of the domicile of the securities or that of the corporation owning them. (Letter from Treasury Department dated June 6, 1916; I. T. S. 1917, ¶ 1505.) In DeGanay v. Lederer, 239 Fed. 568, it was held that the income tax properly applied to income on domestic securities owned by a non-resident alien, which securities were kept in this country.

Deductions from Gross Income Allowed by Law. The deductions from the gross income of a foreign corporation should as nearly as possible represent the actual expenses and authorized charges incident to the income derived from this country and must not comprehend either directly or indirectly any expenditures or charges incurred in the transaction of business or the investment or capital without the United States.[18] The principle followed by the Treasury Department is that all allowable deductions shall be computed upon a basis which recognizes that the income arising and accruing from business done in and from this country shall bear its share, and no more, of expense incident to the earning or creation of such income in the ratio that the gross income arising in and from this country bears to the entire gross income arising from business done both within and without this country.[19]

WHEN INCOME IS DERIVED FROM INVESTMENTS ONLY. A corporation deriving its sole income from this country in the form of dividends or interest on domestic stocks and bonds is permitted to deduct from the income so received such items of disbursement, loss, etc., as would be properly deductible were the income derived from any other source. The deduction shall comprehend only such expenditures, losses, etc., as are incurred in or are incidental to the creation of the income against which they are charged and in all cases the amounts must be within the limits fixed by law.[20]

18 Reg. 33, Art. 157.

19 Letter from Treasury Department dated July 18, 1916; I. T. S. 1917, ¶ 1114.

20 Letter from Treasury Department dated June 6, 1916; I. T. S. 1917, ¶ 1505.

ORDINARY AND NECESSARY EXPENSES. A foreign corporation may deduct all the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity. This chapter contains only the rulings applicable to foreign corporations. The chapter on domestic corporations should be read as well as the chapters discussing the general provisions relating to deductions. Where certain expenses such as coal, ships stores, etc., in the case of foreign steamship companies, cannot be segregated the total expenses of the foreign corporation for such items should be pro-rated in such proportion as the gross income of the corporation from sources within the United States bears to the gross income derived from all sources both within and without the United States, that is to say, if one-half of the gross income of the foreign corporation is from this country one half of such expenses would be proper deduction.[21]

LOSSES. All losses actually sustained within the year in business or trade conducted by the foreign corporation within the United States and not compensated by insurance or otherwise may be deducted including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade, within the limits permitted to domestic corporations. It should be noted that losses which may be deducted are those sustained in the business conducted

21 T. D. 1675; Reg. 33, Art. 116; Letter from Treasury Department dated December 8, 1916.

in the United States and depreciation may be deducted only on property used in connection with such business. The general rulings relating to losses and depreciation are discussed in the chapters on deductions.[22] No rulings or decisions especially applicable to foreign corporations have been made with reference to these deductions.

DEPLETION OF NATURAL RESOURCES. Foreign corporations owning mines or oil and gas wells in this country are entitled to the same allowances for depletion of the natural resources as are permitted to domestic corporations and individuals. For a discussion of these allowances see the chapters on depletion.[23]

DEDUCTIONS FROM INCOME OF FOREIGN INSURANCE COMPANIES. The special deductions allowed in the case of insurance companies, domestic and foreign, are treated in the foregoing chapter.

INTEREST. Foreign corporations are permitted to deduct a part of the interest paid during the year under the following rules. The amount of indebtedness on which the interest may be deducted must be an amount not in excess of the entire amount of the paid up capital stock outstanding at the close of the year, or if no capital stock, the entire amount of the capital employed in the business at the close of the year plus one half of its interest-bearing indebtedness then outstanding, that is to say, the greatest amount of interest which a foreign corporation can deduct is limited in the same way as in the case of domestic corporations. The dis-

22 See Chapters 31 and 32.
23 See Chapters 33 and 34.

cussion of this limitation in the Chapter on Corporations applies equally to domestic and foreign corporations.[24] If the foreign corporation does all its business in the United States the interest on the amount of indebtedness ascertained as above may be deducted. If it does only a part of its business in the United States there may be deducted only the interest paid on such proportion of the amount of indebtedness ascertained as above as the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States. As in the case of all other taxpayers, foreign corporations are not permitted to deduct the amount of interest on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from the income tax.

INTEREST ON INDEBTEDNESS SECURED BY COLLATERAL. The provision of law permitting a deduction to domestic corporations of the full amount of interest paid on indebtedness secured by collateral the subject of sale or hypothecation in the ordinary business of the corporation is not allowed by the law to foreign corporations.

INTEREST PAID BY BANKS ON DEPOSITS. A foreign bank, banking association, loan or trust company, or branch thereof, may deduct in full the interest paid within the year on deposits by or on moneys received for investment from either citizens or residents of the United States and secured by interest-bearing certificates of indebtedness issued by such bank, bank association, loan or trust company or branch thereof. Interest so paid to citizens and residents being taxable as income to them

24 See Chapter 12.

is properly deductible from the income of the foreign corporation.

TAXES. A foreign corporation may deduct taxes paid within the year imposd by the authority of the United States (except income and excess profits taxes) or its territories or possessions or under the authority of any state, county, school district or municipality or other subdivision of any state, paid within the United States, not including those assessed against local benefits. This allowance for taxes is the same as that allowed to domestic corporations and to individuals except that it is expressly limited to cases where the tax is assessed by a governmental authority within the jurisdiction of the United States and the tax paid within the United States. For a general discussion of the extent to which taxes may be deducted see the Chapter on Deduction of Taxes.[25]

Duty of Foreign Corporations in Paying Out Income. Where a resident alien corporation pays out income to others subject to the tax it is subject to all the duties and responsibilities imposed upon domestic corporations as to withholding the tax at the source or reporting the names of the persons to whom such income is paid. For a further discussion of this subject see the Chapter on Collection at the Source and the Chapter on Information at the Source. Non-resident alien corporations are under no duty in paying out net income to others whether or not such payees are citizens or residents of this country.

Return of Annual Net Income. Foreign corporations deriving income from sources within this country are

25 See Chapter 30.

required to file a return of annual net income in the same manner as required of domestic corporations, and the Chapter on Corporations should be read in this connection.[26]

When Filed. A foreign corporation may file its return for the calendar year, on or before March 1 of the year following, or may duly designate a fiscal year in the manner indicated in the Chapter on Corporations, and file its return within sixty days after the close of such fiscal year. The time for filing returns of foreign corporations may be extended as stated in the chapter containing the general provisions relating to returns.[27]

Where Filed. The return is filed in the case of a foreign corporation in the office of the collector of the district in which is located its principal place of business in the United States, or if it has no principal place of business, office, or agency in the United States, then in the office of the Collector of Internal Revenue at Baltimore, Maryland. Where returns for a foreign corporation are filed by an agent in this country, the place of filing is the office of the collector of the district in which the agent has his place of business or residence.

By Whom Filed. The responsibility for filing the return rests in some cases on the agent of the foreign corporation in this country as indicated in the Chapter on Agents for Non-resident Aliens and Foreign Corporations. When the return is filed by the officers of the corporation the agent of the corporation in this country is relieved of responsibility. As to the filing of

26 See Chapter 12.
27 See Chapter 35.

returns in the case of bankruptcy or dissolution see the Chapter on Corporations. Foreign corporations having several branch offices in the United States should designate one of such branches as the principal office and should also designate the proper officer to make the required return.[28] Agents for foreign steamship companies may sign the required returns if so authorized by their companies.

HOW PREPARED. The return is prepared in the same manner as returns by domestic corporations except that the statements should relate to income from sources within this country and the deduction should be limited as above indicated. As to the general requirements to be observed in preparing the return see the Chapter on Corporations.

HOW SIGNED AND SWORN TO. In case the return is filed by the home office of the corporation it should be sworn to by the president, vice-president or other principal officer and by the treasurer or assistant treasurer and be verified in the same manner as required in the case of domestic corporations. As to the general provisions respecting the oath or affirmation see the Chapter on Reports.[29] Where the return is signed by the agent for the corporation, resident in this country, the affidavit on the form should be changed to show that the report is made by such agent and covers all the income coming into his hands, or all the income of the corporation from sources within the United States, as the case may be.

Special Returns by Corporations. Resident alien corporations are required to make the same special re-

[28] Reg. 33, Art. 83.

[29] See Chapter 35.

turns as domestic corporations. Non-resident alien corporations are not required to make special returns by any express provision of the law, but may be called upon under general provisions of the law for information respecting their income from sources within this country.

CHAPTER 15

EXEMPT CORPORATIONS

Section 11 of the 1916 Law expressly exempts fourteen classes of corporations from the tax. The first eight of these classes were exempt under the 1913 Law, the last six classes were added by the 1916 Law. Exempt corporations under the 1913 Law were exempt from all provisions of the law, and it was held that this included exemption from the duty of acting as withholding agent. The exemption of the 1916 Law is limited to the tax and to the making of the return of annual net income.[1] Exempt corporations are now required to withhold the tax at the source and to report payments of income to others, in the same manner as is required of taxable corporations.[2] Corporations exempt under the 1916 Law are also exempt to the same extent under the 1917 Law.

Foreign Corporations. The provisions of Section 11 of the 1916 Law are held to apply to foreign corporations as well as to domestic corporations, except as to building and loan associations and co-operative banks. In case a foreign organization desires to be held exempt from the law, and a doubt exists as to whether or not it comes within the class of organizations enumerated in Section 11, it will be required to file a copy of its

1 Act of September 8, 1916, § 13.
2 T. D. 2407.

Charter and By-laws and an affidavit executed by its principal officer showing the disposition made of such income as it receives and stating specifically whether or not any of the income so received inures to the benefit of any individual stockholder. The question of whether or not the organization will be held to be exempt is determined by the Treasury Department upon the facts so shown.[3]

Exemption Limited to Classes Specifically Enumerated. Any corporation, no matter how created or organized, or what the purposes of its organization may be, is taxable unless it comes within the classes of organizations specifically enumerated as exempt. A corporation is not exempt simply and only because it is primarily not organized and operated for profit. If income within the meaning of the law arises and accrues to a corporation, such income will be subject to the tax unless it is one of the exempt organizations expressly enumerated in Section 11. Thus, commercial men's associations, and like organizations are not exempt, as they are not expressly enumerated, although they may be corporations not organized for profit.[4]

Where Question as to Right of Exemption Exists. Where there is any doubt as to the status of a corporation under the provisions of the law, and its exempt status has not been established by the Treasury Department, the annual return should be filed (in blank if

[3] Letter from Treasury Department dated December 6, 1916; I. T. S. 1917, ¶ 1134.

[4] Reg. 33, Art. 80; T. D. 2152. This Treasury decision also held farmers' mutual fire insurance companies to be taxable, but the 1916 Law subsequently expressly exempted such organizations

desired) and an affidavit attached thereto setting out fully the nature and purpose of the organization, the source of its income and what disposition is made of it and particularly of any surplus.[5]

Right of Exemption Must Be Proved on Request. Corporations enumerated as exempt may at the request of the Collector or Commissioner of Internal Revenue, be required to establish their right by showing the character and purpose of the organization, the manner of distributing the net income, if any, or that none of the net income inures to the benefit of any private stockholder or individual. In the absence of such a showing such organizations may at any time be required to make returns of annual net income or disclose their books of account to a revenue officer for examination in order that the status of the company may be determined.[6] Having once satisfied the collector as to its right to exemption a corporation is not required to make any further showing in subsequent years unless the collector has reason to believe that the status of the organization has changed, or that its net income is inuring to the benefit of the stockholders or members.[7]

Labor, Agricultural and Horticultural Organizations (first class). Although the law exempts these organizations without any qualification, the exemption is undoubtedly intended to apply only to such organizations as are not organized for profit but are organized for the mutual welfare of their members. Thus agricultural

5 Reg. 33, Art. 91; Letter from Treasury Department dated November 1, 1916; I. T. S. 1917, ¶ 1133.

6 Reg. 33, Art. 88.

7 Mimeograph letter to Collectors No. 1148.

corporations owing sugar plantations and disposing of the product thereof have been held by the Treasury Department to be organized for profit and not entitled to exemption as agricultural organizations under this provision.[8] County fairs or like organizations not themselves engaged in agricultural or horticultural pursuits, but which, by means of awards, premiums, etc., are intended to encourage better production, and no part of whose income inures to the benefit of any private stockholder or individual, are held to be exempt.[9]

Mutual Savings Banks (second class). The mutual savings banks which are exempt are those not having a capital stock represented by shares. As to what constitutes a mutual purpose see the discussion in the paragraph on building and loan associations below.

Fraternal Beneficiary Societies (third class). Fraternal beneficiary societies, orders or associations are exempt if they operate under the lodge system or if they are for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and if they provide for the payment of life, sick, accident, or other benefits to the members of such society, order or association or their dependents. One important characteristic of this class of exempt corporations is that they must operate under the lodge system or be for the exclusive benefit of a society operating under such system. Such a society or organization is considered to be one organized under a charter, with properly appointed or elected officers, with an adopted ritual or ceremonial, holding meetings at stated intervals, and supported by

[8] T. D. 2090.
[9] T. D. 1737.

fees, dues or assessments.[10] Mutual protective associations, not operating under a lodge system are not exempt under this provision since they lack one of the characteristics of this class.[11]

Domestic Building and Loan Associations and Co-operative Banks [12] (fourth class). A domestic building and loan association is held to be one organized under the laws of the United States or of a state or territory or under the laws applicable to Alaska or the District of Columbia. Mutuality in operation and in the distribution of profits and benefits is essential to exemption In order to come within the exempted class such associations must not only be domestic but they must be without capital stock and be organized and operated exclusively for mutual purposes and without profit; that is, all the profits and benefits provided for in the articles of association and by-laws must be ratably distributed among all the members, regardless of the kind of stock held, according to the amount of money they have on deposit. An association issuing different classes of stock upon which different rates of interest or dividends are guaranteed or paid is not in the exempt class.[13] Under the 1909 Law it was decided that a building and loan association was exempt although it issued both prepaid and instalment stock. but that one issuing preferred stock was not exempt.[14] Mutual benefit does not necessarily

10 Reg. 33, Art. 89.

11 Commercial Travelers Life and Accident Association v. Rodway, 235 Fed. 370. This case contains an extended discussion on the distinction between a mutual association and a fraternal association.

12 Co-operative banks were included by the 1916 Law.

13 Reg. 33, Art. 87.

14 Pacific Bldg. & Loan Ass'n v. Hartson, 201 Fed. 1011.

mean equal benefit. A building and loan association is organized and operated for the mutual benefit of its members when they share in the profits on substantially the same footing. Exact equality is probably not possible where part of the stock is prepaid and part is instalment, but an approximate equality sufficiently close for all purposes is certainly not beyond the reach of calculation.[15] Building and loan associations are not exempt if they loan money to others than their members, thus doing business similar to that engaged in by banks or trust companies. Building and loan associations which receive sums of money on deposit which is not payment of stock, and on which the depositor receives a fixed rate of interest, regardless of the earnings of

[15] Herold v. Parkview Building and Loan Association, 210 Fed. 577. The association issued two varieties of stock, one known as prepaid stock on which the full par value of $200 per share was paid by the holder at the time of the issuance of the stock, and upon which the Company paid to the holder out of the profits of the association the sum of 5% per annum in lieu of participation by said stockholder in the general profits of the association, and a second stock known as instalment stock whereon the holder paid one dollar per share per month and to which was added the proportionate share of the profits of the association after deducting expenses until the aggregate of payments and profits equaled the sum of $200, when the said sum was paid to the holder and the shares retired. The prepaid stock could be cancelled by the corporation at any time upon thirty days' notice and payment of the value thereof together with interest at the rate of 5% from the date of last payment of interest, and each holder of such stock could likewise upon thirty days' notice tender his certificate and require payment from the association. The association borrowed no money from individuals whether members or nonmembers, loaned no money to persons other than members of the association, but borrowed according to its business demands from a local bank. The association was organized under the Act of April 8, 1903 (Public Laws, p. 457) of New Jersey.

the association, are conducting a business similar to a banking business, and are therefore subject to the tax,[16] unless they fall within the class of co-operative banks.

Cemetery Companies (fifth class). A cemetery company is exempt if it is owned and operated exclusively for the benefit of its members. Companies which operate cemeteries for profit are not exempt.[17]

Religious, Charitable, Scientific and Educational Organizations (sixth class). Corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purpcses are exempt if no part of the net income accruing to the association inures to the benefit of any private stockholder or individual.

Business Associations (seventh class). Business leagues, chambers of commerce and boards of trade, not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual are exempt. It will be noted that only three kinds of business associations are enumerated in this section and as the law is strictly construed as to exemptions other business associations would not be exempt even though organized not for profit.

Civic Organizations (eighth class). Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt.

Clubs (ninth class). Clubs organized and operated exclusively for pleasure, recreation and other non-profit-

16 T. D. 1655.
17 Reg. 33, Art. 90.

able purposes are exempt if no part of the net income inures to the benefit of any private stockholder or member.[18] A club desiring to be registered as exempt should file with the Commissioner of Internal Revenue a copy of its charter or an affidavit of its principal officer setting forth the nature of its organization, the purpose for which it was organized, the source, if any, from which it derives income, and the disposition made of such income.[19] It should, in addition to the disposition of its income, particularly show any surplus, and whether or not such surplus will ever inure to the benefit of any private stockholder or individual.[20]

CLUB—ACCUMULATING CHRISTMAS FUND. An incorporated club, composed of the employees of a corporation, was organized for social purposes. The only source of income of the club was the initiation fee, and this was expended solely for entertainments. Certain members, called participating members, made contributions to a "Christmas Fund," which fund was invested by the executive committee of the club as it saw fit. Shortly before Christmas in each year the investments were liquidated and the net fund distributed to the participating members in proportion to their contributions. It was held that the club was organized and operated exclusively for pleasure, recreation and other non-profitable purposes and that no part of its net income inured to the benefit of any private stockholder or member. The

18 Such clubs were held to be exempt under the 1913 Law, although that law did not contain the express exemption which appears in the 1916 Law. (Letter from Treasury Department dated March 4, 1914; I. T. S. 1917, ¶ 1144.)

19 T. D. 2090.

20 Letter from Treasury Department dated February 12, 1916; I. T. S. 1917; ¶ 1146.

fact that the executive committee received specific dues from certain members, to be invested in various ways and thereby derived income did not take it out of the exempt class, since the funds so received were not the property of the club and were returned, together with the profit thereon, to the contributing members.[21]

Mutual or Co-operative Organizations of a Local Character (tenth class). Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, and like organizations of a purely local character, the income of which consists solely of assessments, dues and fees collected from members, for the sole purpose of meeting expenses, are exempt. It should be noted that the essential features of this class are as follows: (a) They must be mutual or co-operative; (b) they must be of a purely local character; (c) the income must be solely from assessments, dues and fees collected from members, and such assessments, dues and fees must be used for the sole purpose of meeting expenses.

CO-OPERATIVE DAIRIES. Under the 1913 Law which did not contain the foregoing exemption it was held that co-operative dairy associations, whether issuing capital stock or not, were not exempt as agricultural organizations. In the preparation of their returns such associations were permitted to deduct from gross income the amount actually paid to members and patrons for milk, but any amount retained at the end of the year over and above expenditures was taxable as income.[22] This would hold true under the foregoing exemption, but co-

21 Letter from Treasury Department dated January 12, 1917.
22 T. D. 1996.

operative dairy associations are now exempt if they have the characteristics indicated in the preceding paragraph.

Associations for Marketing Produce (eleventh class). Farmers', fruit growers' or like associations, organized and operated as sales agents for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them, are exempt.

Corporations Owned by Exempt Corporations (twelfth class). Corporations or associations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to organizations which are themselves exempt from the income tax are also exempt. Such corporations were held to be taxable under the 1913 Law in the absence of an express provision in that law for their exemption.[23]

Federal Land Banks and National Farm-Loan Associations (thirteenth class). Such banks and associations as provided in Section 26 of the Act of July 17, 1916, entitled "An act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes," are exempt.

Joint Stock Land Banks (fourteenth class). Such banks are exempt as to income derived from bonds or

[23] T. D. 2137.

debentures of other joint stock land banks or any federal land bank belonging to such joint stock land bank. They are taxable, however, as to income from other sources and consequently it would seem are not exempt from the requirement of making a return of annual net income since the exemption from making returns applies only to corporations not subject to the tax.[24]

Income Accruing to State or Local Governments. In addition to the fourteen exemptions noted above Section 11 of the 1916 Law provides that income shall not be taxed if it is derived from any public utility or from the exercise of any essential governmental function and accrues to any state, territory or the District of Columbia or any political subdivision of a state or territory. It also provides that no income accruing to the government of the Philippine Islands or Porto Rico or the government of any political subdivision of those possessions shall be taxed. Where a state, territory or the District of Columbia, or any political subdivision of a state or territory, has prior to the passage of the law entered into a contract with any person or corporation to acquire, construct, operate or maintain a public utility no tax is levied upon the income derived from the operation of such public utility so far as the payment thereof will impose a loss or burden upon such state, territory or district or political subdivision. This provision entitles the owner of such public utility, whether a person or a corporation, to deduct the amount of income paid to the state or local government as its share, and the rulings thereon are contained in the chapters on Deductions.[25]

24 Act of September 8, 1916, § 13, ¶ (b).
25 See Chapter 28.

Federal Reserve Banks. The income of Federal Reserve Banks is exempt from income tax by express provision in the Federal Reserve Act.[26] The dividends on the stock of such banks are exempt from tax in the hands of member banks.[27]

26 Federal Reserve Act, 38 Stat. 251, Ch. 6, § 7.
27 Federal Reserve Bulletin, April 1, 1916.

CHAPTER 16

INCOME—IN GENERAL

A discussion of the various conceptions of income would be interesting but is out of place in a work of this character. For all practical purposes it is sufficient to state that the income which is taxable under the present laws is defined in the statute. One conception of income excludes gains or increment in the value of capital assets, but this conception was not that of Congress, since the tax is not only upon income conceived as a production of capital, but also upon gains and profits derived from sales or dealings in property, growing out of the ownership or use of or interest in property or from gains or profits from any source whatever. For the purpose of discussion in this and the following chapters, the general rules and principles applicable to income from all sources will first be described, and thereafter, the special rules applicable to income from personal services, income from farming, income from business, trade and commerce, income from dividends, income from interest and rent, and income from miscellaneous sources. The special rules relating to income from partnerships and income from fiduciaries are treated in the chapters on those respective subjects.

What Constitutes Income. The word "income" as used in revenue legislation has a settled legal meaning. The courts have uniformly construed it to include only

the receipt of actual cash as opposed to contemplated revenue due but unpaid, unless a contrary purpose is manifest from the language of the statute. What was taxed by the 1909 Law was "net income received," not income, accruing or accrued, which had not been received and portions of which might never be received. While the phrases "income received" and "income accrued" are frequently used in the same statute, the courts have not departed, unless it expressly appears otherwise, from a construction of the law in accord with an intention to reach the actual and not the potential income. In the 1913 Law the two preceding phrases were employed. Doubtless it was the intention of Congress to employ terms of sufficient comprehension to reach the actual income by foreclosing any possible avenue of escape, but it can hardly be said that in so doing an intention prevailed to tax that which did not actually exist, except on paper, as income accrued during the taxing period. One cannot be said to receive an income of defined proportions until he balances receipts and deductions at the end of a stated period and ascertains, not what is due, but what has been actually received. The assets and liabilities may be measured by a different rule of accounting, but income as defined by the courts means, as said in United States v. Schillinger,[1] "in the absence of any special law to the contrary, income must be taken to mean money, and not the expectation of receiving it or the right to receive it at a future time."[2] In the 1916 Law the phrase "income received" is used with respect to both individuals and corporations.[3]

[1] 14 Blatch. 71.

[2] Maryland Casualty Co. v. U. S., Ct. Cls., T. D. 2451.

[3] The language of the 1909 Law was also held to indicate that

Actual Receipts. The 1916 Law intends primarily to tax individuals and corporations upon the income received, and not that which has arisen or accrued, but has not been received.[4] This basis of actual receipts is not exclusively prescribed, since both individuals and corporations may, if they so choose and the Commissioner of Internal Revenue permits them, report their net income on the basis of accruals instead of actual receipts. This provision is more fully discussed in subsequent paragraphs of this chapter. If the taxpayer does not elect to report on such basis, or is not permitted to do so by the Treasury Department, the tax must be computed on the basis of actual receipts. An early ruling of the Treasury Department, under the 1913 Law, holding that a person receiving fees or emoluments for professional services must include all actual receipts for services rendered in the year for which the return was made, together with all unpaid accounts, charges for services or contingent income due for that year, was discussed in the case of Edwards v. Keith,[5] and the court said: "No such construction of the Treasury Department can enlarge the scope of the statute so as to impose the tax upon unpaid charges for professional services rendered, which for aught anyone can tell may never be paid. The statute alone determines what is income to be taxed. It taxes only income derived from many specified sources, and one does not derive income by rendering services and charging for them." Accrued

the net income, which was the measure of taxation, meant what had actually been received and not that which, although due, had not been received, its payment for any reason having been deferred or postponed. (Mutual Benefit Life Insurance Company v. Herold, 198 Fed. 199.)

[4] Act of September 8, 1916, § 1 and § 10.

[5] 231 Fed. 110.

but unpaid interest on investments has been held not to be income.[6] Under the broader language of the 1909 Law it was held that income was taxable only to the extent that it was actually received during the year, and did not include items which had been earned, or become due, but had not been collected.[7] It was also held under that law that items of "non-ledger assets" shown in the annual report of a life insurance company, made in pursuance to a state statute as "uncollected and deferred premiums" and "interest due and accrued," but no part of which had been received, were not a part of the company's "income received during such year."[8]

Bookkeeping Entries. Real facts and not bookkeeping entries constitute income.[9] This does not mean that the return of net income should not be made in accordance with the taxpayer's books, for ordinarily the books reflect the real or actual facts. It means, for instance, that if the taxpayer is reporting on the basis of actual receipts and disbursements, the entry of charges not yet collected will not make him taxable thereon. In brief, the taxpayer is not precluded, by the entries in his books of account, from reporting his income according to actual facts, nor on the other hand is the Government precluded from going behind the taxpayer's books and assessing the tax on the actual facts. In some instances the law places a determining importance on

6 Insurance Company of North America v. McCoach, 218 Fed. 905.

7 Connecticut Mutual Life Insurance Co. v. Eaton, 218 Fed. 206.

8 Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188.

9 Mitchel Brothers v. Doyle, 225 Fed. 437; U. S. v. Nipissing Mines Company, 202 Fed. 803; Baldwin Locomotive Works v. McCoach, 215 Fed. 927; U. S. v. Guggenheim Exploration Company, 238 Fed. 231.

bookkeeping entries, as in the case of depreciation and losses of corporations, which must be sustained and "charged off" in order to be deducted. In the case of individuals, losses need not be "charged off" except in the case of worthless debts. The latter seems to be the only item of income or deduction expressly required by the law to be evidenced by book entries in the case of individuals. The Treasury Department, however, insists upon book entries of other deductions before allowing the same. If the individual keeps books of account it is no doubt within the power of the Treasury Department to require entries of deductions to be made for the purpose of record, but a taxpayer, not keeping books, is not for that reason precluded from claiming the deductions specified in the law, except in the case of worthless debts, as noted above. No particular system of bookkeeping or accounting is required by the department, but the business transacted by the taxpayer should be so recorded that each and every item set forth in the return of annual net income may be readily verified by an examination of the books of account.[10] The books of a corporation are assumed to reflect facts as to its earnings, etc., hence they will be taken as the best guide in determining the net income, and, except as the same may be modified by provisions of the law wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to stockholders, should be the same as that returned for taxation.[11] Where an individual or a corporation elects to report on the basis of its books, and not on the basis of actual receipts and disbursements, the books must be

10 Reg. 33, Art. 182; T. D. 2161.

11 Reg. 33, Art. 183.

kept according to standard accounting systems. This basis is more fully discussed in the latter part of this chapter.

Book Value of Assets. Neither the Government nor the taxpayer is bound by valuations entered on the books of the taxpayer.[12] Where property is carried at nominal value on the books of the taxpayer, and the Government seeks to assess a tax on the basis of that value, the taxpayer may prove, by other evidence, the true value of such property.[13] A book value increase in the value of capital assets due to a re-appraisal of property is not income within the meaning of the law.[14] A book entry reflecting only an enhanced value of assets during the year evidences an increase in the net worth of the corporation or individual for that year, an increase which, under adverse conditions, may disappear the next year. An increase in value thus evidenced is intangible, unstable and is not such income as the law contemplates shall be returned for the purpose of the tax.[15] Returnable and taxable income is that actually realized during the year, evidenced by the receipt of cash

12 Doyle v. Mitchell, 235 Fed. 686.

13 U. S. v. Guggenheim Exploration Company, 238 Fed. 231. In this case the value at which the property was acquired, the declaration of the board of directors as to such value, at the time of acquisition, and statements in the annual reports, were held to overcome in weight the alleged admission against interest in placing the valuation of the property on the books at a nominal amount.

14 T. D. 2005, Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

15 Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 260.

or its equivalent. Hence mere book entries of an appreciation in the value of capital assets will be disregarded.[16]

Inventory. Taxpayers engaged in manufacturing or mercantile businesses usually determine their net income by inventory, purchases during the year plus the stock on hand at the beginning of the year, being subtracted from sales during the year plus stock on hand at the close of the year, or vice versa, to ascertain the gain or loss. The Treasury Department recognizes this system, but requires that in every case where the annual gain or loss is determined by inventory, the merchandise must be inventoried at cost price, as any loss in salable value will ultimately be reflected in the sales during the year when the goods are disposed of. Overhead charges are not to be included in inventory.[17]

Income Received in Kind. When income is received in kind, that is, in produce, crops, or other property having no definite money value, the tax is assessible in the year in which such income is reduced to money or a money equivalent.[18] If property is exchanged or bartered for other property, neither having a fixed or determinable money value, and the exchange is not made on the basis of money value, no taxable income arises from the transaction. Thus, an exchange of one horse for another horse, does not create taxable gain to either party to the transaction though each may feel convinced he is the richer by the deal. If either party subsequently sells the horse received by him in the exchange, his profit will then be the difference between the selling

16 Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 1249.

17 See instructions on back of Form 1031.

18 T. D. 2153.

price of that horse and the cost to him of the horse he first owned. Rulings on this point have not been very well defined by the Treasury Department up to the present time. It has held, however, that "if assets are exchanged for other assets of a like character, and no account is taken of the compensatory value, it will be held that such a transaction constitutes merely a change in the form of assets, and the investment will be considered a continuing one, no profit or loss to be taken into account until the assets are disposed of for cash or its equivalent." [19]

Income Received in the Equivalent of Cash. The law expressly provides that stock dividends shall be taxable to the same extent as though the surplus they represent had been distributed in cash. Salaries, wages or compensation for personal services of whatever kind "and in whatever form paid" are taxable income. These are the only instances in which the law expressly imposes a tax on income received in any form other than cash. The Treasury Department, however, has ruled in a number of cases that income may be taxable without necessarily being received in the form of cash. Thus, it has held in some cases that payment made by the issue of stock of a corporation is equivalent to payment in cash, but the rulings on this point are not yet very well defined. The transactions with respect to which such rulings have been made involve two points: (a) whether the transaction is one in which any income can be said to have arisen, and (b) whether the consideration received has a sufficiently fixed and definite money value to be considered the equivalent of cash.

[19] Letter from Treasury Department dated August 3, 1917; I. T. S. 1917, ¶ 2281.

The difficult questions arising in this connection are discussed in the following paragraphs.

CHANGE OF INVESTMENTS. Where a broker induces a customer to change his investments, on the basis of market prices at a certain time, the difference in prices being adjusted by cash payment, such a transaction seems clearly to be one in which each party is able to compute in money values his gain or loss. Thus, as an illustration, Jones may have purchased a bond for $900, and Smith may have purchased ten shares of stock for $850. The market for each investment having gone up ten points, Jones and Smith exchange investments, Smith paying $50 additional in cash. As a result, Jones is in possession of stock having a market value of $950 and $50 in cash, while Smith has a bond with a market value of $1,000, but his amount of cash is reduced by $50. Upon analysis it is seen that the transaction is in fact a double one equivalent to each party having paid the other in cash the full market value of the security, and having purchased from the other, for cash, a new security. Each has clearly realized a gain of $100 and, with respect to each, the transaction is a closed and completed one. It seems clear, therefore, that each should report income of $100 in his annual return. It would also seem that the same rule applies upon the exchange of any property having a definite and generally recognized money value, and the exchange is made on the basis of such money value. Whether or not it can properly be applied to an exchange of property, where the value is a matter of speculation, has not been determined, but it seems that a transaction under such conditions is not contemplated by the law to be capable of producing taxable income.

STOCK RECEIVED IN EXCHANGE FOR SERVICES. An early ruling of the Treasury Department, under the 1913 Law, held that commissions allowed salesmen, paid in stock, might be deducted as expense, if so charged on the books of the corporation, at the actual value of such stock.[20] This is apparently on the theory that the transaction was equivalent to the salesman receiving payment for his services in cash and immediately investing the sum in stock. Conversely, the Treasury Department would no doubt hold, in order to be consistent, that the value of the stock would be income to the salesman as a payment in the equivalent of cash. It would seem to be more sound, however, to argue that the salesman received for his services merely the right to share in the future profits of the company, and in its assets upon dissolution, and received no present taxable consideration, especially if the stock had no definite market value. Of course, adopting this theory, the salesman would be taxable upon the entire amount received in case any of the stock should be sold, since the stock would be held to have cost him nothing, while if he reports the value of the stock as income at the time of receiving the stock, that amount may be deducted from the selling price in computing the taxable profit on a subsequent sale of the stock. In the absence of more definite rulings on this point, it would seem that the transaction could be handled according to the intent of the parties, since, as a practical matter, if a corporation deducts the value of the stock so paid for services, the employee receiving the stock should report the sum as income, and, conversely, if the corporation does not deduct the value of the stock as an expense, the employee should not be required to include it as income. It is

[20] Reg. 33, Art. 117.

entirely a question of who should assume the burden of the tax.

STOCK RECEIVED IN EXCHANGE FOR PROPERTY. If an individual conducting business by himself decides to incorporate and legally transfers his property to a corporation in exchange for its stock it does not seem that he should be taxed on the theory that he has received payment in the equivalent of cash, since he cannot possibly be any richer as a result of the transaction, and his apparent profit, if any, is a mere "paper profit," not an actual profit. It is argued, on the other hand, that he has gone through all the legal forms of a sale and that the legal form must govern, but it does not seem, nevertheless, that he is in receipt of actual income such as the courts indicate the law attempts to reach. The conclusion would not appear to be different if several individuals pool their property and form a corporation, since where property is transferred to a new corporation in exchange for its stock, the transaction is essentially a contribution of property to the common fund in anticipation of receiving a definite proportion of the profits resulting therefrom. The transactions are confusing because of the legal theory that a corporation is an entity separate and apart from its shareholders, and such transactions, whereby property is contributed to a corporation, usually take the form of a sale between two separate entities. The attitude of the Treasury Department indicates that such transactions will be considered as sales between separate entities and held to be completed and closed transactions with respect to the stockholders. The second difficulty involved in such transactions is that it is impossible, in many instances, to determine with any degree of certainty the money value of the

stock received. A custom has grown up in this country of placing high valuations on property contributed to a corporation, in order that a greater par value of stock may be issued therefor without subjecting the stockholder to liability for unpaid stock. The expected value of the property after a period of development is often capitalized, and future earnings are anticipated. We capitalize our corporations at a par which we hope to reach, instead of at a par representing the present value, consequently property is often transferred to corporations upon a valuation fixed by the directors in such sums as to create a tremendous "paper profit" to the stockholders who contribute property in exchange for the stock. As a practical matter, such transactions are not considered by the parties thereto as "closed and completed" within the sense that the phrase is used in the income tax regulations. The forms observed in the transaction and the seeming profit creates a problem which the Treasury Department has proceeded to solve in the cases that have come before it in such way as to create revenue, as is indicated in the following paragraphs.

REORGANIZATION OF CORPORATIONS. It has been held "that in all cases wherein a corporation sells and transfers its assets to another corporation, the amount received by the selling corporation in excess of the cost of the property sold will be considered income to such selling corporation."[21] This, of course, is true but the Treas-

21 Letter from Treasury Department dated September 9, 1916; I. T. S. 1917, ¶ 1218. The original rulings of the Treasury Department were to the effect that upon a reorganization where a new corporation was formed with a larger par value, the transfer of the assets from the old to the new and the exchange of stock by

ury Department implied in this ruling that payment in stock was to be considered equivalent to payment in cash, and stated that if the shares of stock received by the selling corporation were distributed to its stockholders, the amount so distributed in excess of the stock (meaning apparently par value) held by them in the selling company would be considered income to the stockholders, to be returned as dividends. In later rulings it was held as indicated below.

WHERE EXCHANGE IS PAR FOR PAR. Where in the case of reorganization new stock is acquired by a stockholder in exchange for old stock and both are of the same par value no income arises at the time of exchange, but when the new stock is sold the gain must be based upon the cost of the old stock or its value on March 1, 1913.[22] Where upon reorganization of a company stock of the new company is issued in exchange for shares of the old, the new company taking over the property

the stockholders of the old for a greater par value of stock of the new, did not create taxable income. Letter from Treasury Department dated May 3, 1915; I. T. S. 1917, ¶ 1211; letter from Treasury Department dated April 1, 1915; I. T. S. 1917, ¶ 266; in the latter ruling it was said, "In this transaction there is nothing to indicate that the two shares of stock in the B Company of a par value of $100 each, had a value in cash or its equivalent in excess of the value of the stock in the A Company. There is no evidence other than the difference in the quantitative par value of the shares of stock, that any gain, profit or income was realized from the exchange of the shares of stock. It is therefore the opinion of this office that no accounting of income will be required until such time as the individual in question sells the stock of the B Company at a price in excess of the capital which he originally invested in the stock of the A Company."

[22] Letter from Treasury Department dated March 8, 1917; I. T. S. 1917, ¶ 2121.

of the old, no income accrues if the exchange of stock is share for share of like par value even though the property of the first corporation has increased in value over a period of years since its stock was first issued. Where the stock of both corporations is of like par value and predicated upon exactly the same assets the transaction results in no gains, profits or income to either the first corporation or its stockholders. If the stock of the first company at the time of the transaction was worth "double par" the stock of the second company, being supported by identically the same assets, is presumably of the same value, and the exchange of the new stock for the old results in no income. It is simply an exchange of assets of like character and like value.[23] Where an exchange is made of stock of one corporation for bonds in another corporation, the par value of the stock being equal to the par value of the bonds, no taxable income is held to result from the transaction, the transaction being an exchange of assets of a different form but of equal value.[24]

WHERE THE EXCHANGE IS FOR A GREATER PAR VALUE. Where the assets of one corporation are transferred to another, the stockholders of the first receiving in exchange for their stock a greater amount of stock, par value, in the new corporation, the attitude of the Treasury Department seems to be that the par value of the new stock is to be considered as the equivalent of cash and taxable to the extent that it exceeds the cost of the old. Where the stockholders of a corporation sur-

23 Letter from Treasury Department dated March 8, 1917; I. T. S. 1917, ¶ 2119.

24 Letter from Treasury Department dated August 3, 1917; I. T. S. 1917, ¶ 2281.

rendered their stock for stock of less par value, they were permitted to claim a loss on the difference between the cost of the old and the par of the new.[25]

WHERE THE NEW STOCK HAS A MARKET VALUE. Where a stockholder holding shares in a company receives upon reorganization the same number of shares of the new company, and an equal amount in bonds, the bonds having a ready market value of par, and the stock a value of 50% of par, it was held that the exchange constituted a closed and completed transaction, in that the old stock had been disposed of for a readily determinable value, namely, the par value of the bonds and half the par value of the stock, hence the stockholder had realized on his original investment a profit of 50%, which was required to be returned as income for the year in which the transaction took place. In this particular case it was also held that if the stockholder later on sold the bonds at par, and retained the stock, no income would be realized, and none would be realized until the stock retained had been sold or disposed of for a price or value greater than 50% of its par, which amount was returnable as income under the first transaction.[26]

25 Letter from Treasury Department dated March 9, 1917; I. T. S. 1917, ¶ 2122.

26 Letter from Treasury Department dated August 3, 1917; I. T. S. 1917, ¶ 2281. It is to be noted that none of these rulings on the question of taxable income arising in the exchange of stock have been embodied in formal treasury decisions. They are all contained in letters answering specific questions, but it is a fact, nevertheless, that the Treasury Department is proceeding on the theory that taxable income does arise, and is imposing the tax on such transactions. The only reference to this subject which the author has been able to find in any of the cases is a

Where Surplus of One Corporation Is Converted Into Capital of Another. Whether or not the rulings indicated in the preceding paragraphs on exchange of stock will be upheld by the courts, it seems that it would be sound to take the position, in the case of a reorganization, that if the old company had surplus or undivided profits, which would be taxable if distributed by it as dividends, such surplus and undivided profits would also be taxable if the entire assets were turned over to a new corporation which treated the surplus and undivided profits as being converted into capital and issued its stock to represent the same in an exchange with the stockholders of the old corporation. In such cases the surplus is converted into capital and stock is issued to represent such new capital, thus bringing the transaction within the provisions of the law relating to stock dividends. But even so, the transaction does not come literally within the provisions of law relating to stock dividends, as a stock dividend is defined to be a distribution of profits or surplus payable in stock of the corporation which earned the surplus. However, it would seem that the transaction here described is tantamount to distribution of a stock dividend and should properly be held to be taxable as such.

Payment in Notes. For income tax purposes, where there is an actual sale and transfer of real estate, profit will be considered as realized even though payment is to be made in instalments, as notes for deferred pay-

remark of the lower court in the case of Sargent Land Company v. Von Baumbach, 207 Fed. 423, as follows: "The mere change of form of ownership from that of these individuals to that of a corporation owned by the same individuals cannot produce such large profits as are claimed here."

ments are secured by the title to the property, and presumably bear interest, and are held to be worth, in cash, their face value.[27] In determining the amount of income to be accounted for on this basis, the seller is required to consider mortgages, mortgage notes or any other credits received in payment of the property as though they were cash. If the purchaser should later default in payment, the seller will be permitted to take credit, as a loss, for the amount of loss actually sustained by reason of the default.[28] In case of default on instalment payments, there may be charged off as bad debts the amount of such unpaid instalments, less the salvage value of the real estate repossessed.[29] A promissory note in settlement of an action, or in payment of an indebtedness or of interest, is considered to be the equivalent of cash and so much of such note as represents net income is subject to tax as of the year in which the note is received.[30] This ruling seems hardly supported by the decisions of the courts on what constitutes income. A note is a mere promise to pay, and, at least until the note is discounted, the payee has not in fact received income any more than he has from an unpaid account receivable. To require him to include the amount of notes received in transactions not a part of his business or trade, is unjust, as in case of default he would be entitled to deduct the loss only to a very limited extent or, depending on circumstances, not at all.

Living Quarters, Board or Lodging. In cases where salary, rent, or other income is received in some form

27 T. D. 2090.

28 T. D. 2137.

29 T. D. 2090.

30 Letter from Treasury Department dated March 1, 1915; I. T. S. 1917, ¶ 242.

other than cash, the cash value of such consideration, it is held, should be computed and returned as income. Thus where living quarters are furnished in addition to salary, the rental value of such living quarters should be reported as salary,[31] and where board, lodging, or other consideration is received in lieu of cash, the value thereof should be included as rent or salary, as the case may be.[32] The law expressly provides that salaries, wages, or compensation for personal services shall be taxable "in whatever form paid," but does not so provide with respect to rent. These rulings would be applicable to any payment required by contract to be made in some form other than cash, but it does not necessarily mean that because an employee occupies, rent free, a house owned by the employer, he must return the rental value as income. If it was not stipulated in the contract of employment that such living quarters should be furnished as a part of the salary or wages, the privilege of occupying the house is in the nature of a gift and no taxable income arises. Similarly where an employee uses his employer's property, horses, automobile, etc., by permission, and not by legal right, as a part of his compensation for services, no income arises to him on the ground that he is receiving value for which he would otherwise have to pay. If a person receives a fixed allowance to cover traveling or other expenses and expends less than the sum so received, the excess should be treated as income.

Receipts Representing in Part a Return of Capital. In many cases receipts of money represent in part a return of capital and in part income or profit. Instal-

31 T. D. 2090.
32 T. D. 2135.

ment payments for goods sold is an instance. This subject is discussed in full in a subsequent chapter.[33]

Income Taxable in Year Received. Unless the taxpayer keeps his books on a basis other than that of actual receipts, and reports accordingly, he should report as income all amounts received in the year in which payment is actually made. Thus dividends and interest, salaries, professional fees of lawyers, physicians, and the like [34] need not be returned as income in the year in which they become due or are earned, but should be returned as income in the year in which the payments are received. It is immaterial that the services for which payment may be made have been performed for a period extending over several years, the entire payment is taxable in the year in which received, and may not be pro-rated.[35] In one case it was argued on behalf of an agent of a foreign insurance company, under a contract by the terms of which he should receive compensation on premiums of policies to the extent of certain specified percentages for a term aggregating twenty years from the date of each policy, that all of the labor creating such income had been performed prior to the incidence of the tax, but the court held that fact to be immaterial and sustained an assessment on the entire income for the year in which it was received.[36]

Accounts Receivable. Accounts receivable are considered income for the year in which the account is

33 See Chapter 26.

34 Letters from Treasury Department dated February 18, 1915, and March 1, 1915; I. T. S. 1917; ¶¶ 184, 185 and 228.

35 T. D. 2135.

36 Edwards v. Keith, 231 Fed. 110.

created, since the Treasury Department holds that the net income of taxpayers in manufacturing or mercantile businesses should be ascertained from their books and from the actual inventory of merchandise in accordance with the established procedure in such businesses.[37]

Receipt by Agent Is Receipt by Principal. A system of accounting adopted by an insurance company, which allowed a period of two months to local agencies in which to report their cash premium receipts to the home office, was held, in view of the rules and regulations of the Commissioner of Internal Revenue, not to "clearly reflect" the company's income. A payment to the agent was held to be payment to the principal, and the company was required to include such payments in the return for the year in which they were received by the agent. The provision of the 1916 Law, permitting a corporation to report according to its books, was held not to justify the system followed by the corporation in this case, as the system adopted must be such as to "clearly reflect its income."[38]

Income from Foreign Countries. Where income has accrued in a foreign country on foreign investments but has not been remitted to the owner here, being placed to his credit in the foreign country, he should include the same as income for the year in which it is placed to his credit, computing the amount in United States money by using the rates of exchange prevailing at the time the amounts were credited abroad.[39]

[37] Letter from Treasury Department dated March 31, 1915; I. T. S. 1917, ¶ 241.

[38] Maryland Casualty Company v. U. S., Ct. Cls., T. D. 2451.

[39] Letter from Treasury Department dated January 11, 1916; I. T. S. 1917, ¶ 230.

Income Received from Porto Rico or the Philippines. A corporation or individual whose return under the law is specifically required to be filed with the collector of one of the districts of the continental United States would not be taxable in Porto Rico or the Philippines, although a portion of the income received might be derived from business carried on in one or both of those jurisdictions. Although the law provides that income collected in those jurisdictions "shall accrue intact to the general governments thereof," this refers only to the tax legally assessable therein, and does not alter the general rule that all of the tax shall be paid in the district in which the taxpayer resides or has his or its principal place of business.[40]

Gross Income. The Treasury regulations and rulings refer to gross income generally as the income of the taxpayer before making the deductions and allowances permitted by law. The statute does not use the phrase gross income but in prescribing the deductions allowed to corporations makes use of the phrase "gross amount" of its income. Gross income is not synonymous with gross receipts.

Net Income. The phrase "net income" as used by the Treasury Department seems to mean the amount remaining after subtracting from gross income the deductions allowed by law. In the case of individuals the net income includes the amount received as dividends and the amount of the personal exemption, that is, these amounts are not subtracted from gross income in arriving at what is termed net income but they are subtracted

[40] Letter from Treasury Department dated April 4, 1917.

from net income only in arriving at the net taxable income for the purpose of the normal tax.

Exempt Income. The act specifically prescribes the income which is exempt from tax. The intent seems to be that the income shall be exempt (with four exceptions) regardless of the status or character of the recipient. The four exceptions are (a) proceeds of life insurance policies; such proceeds are exempt only if paid to individual beneficiaries, not to corporations or partnerships; (b) compensation of the President of the United States; (c) compensation of the Federal Judges, and (d) compensation of officers and employees of a state or political subdivision thereof. In the case of the last named class it is held by the Treasury Department that "officers or employees" refer only to individuals. The other provisions as to exempt income have no limitation with respect to the character or status of the recipient and the income would seem to be exempt whether received by an individual, a partnership or a corporation. Such income is as follows: the amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; the value of property acquired by gift, bequest, devise, or descent; interest upon the obligations of a state or any political subdivision thereof or upon the obligations of the United States, (but, in case of the obligations of the United States issued after September 1, 1917, only if and to the extent provided in the act authorizing the issue thereof) or its possessions or securities issued under the provisions of the Federal Farm Loan

Act of July 17, 1916.[41] A more complete discussion of this class of income is contained in the several chapters dealing with the respective kinds of income enumerated.

Reporting Income on Basis of Book Entries. The law provides that an individual or a corporation keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his or its income, may make returns upon the basis upon which the accounts are kept, in which case the tax shall be computed upon the income as so returned. This privilege is subject, however, to regulations made by the Commissioner of Internal Revenue, which regulations may limit the right as the Commissioner sees fit.[42] Taxpayers who do not keep books in accordance with standard systems of accounting will be required to report their net income on the basis of actual receipts and payments, but where books are kept in accordance with standard systems of accounting, or in conformity with the requirements of some federal, state or municipal authority having supervision over the taxpayer, returns may be made on the basis on which such books are kept, provided the books are so kept and the return so made as to reflect the true net income of the corporation for each year.[43]

41 Act of September 8, 1916, § 4, as amended by Act of October 3, 1917.

42 Act of September 8, 1916, § 8 (g) and § 13 (d).

43 T. D. 2433. In this ruling the Treasury Department has placed certain limitations upon the extent to which reserves may be set up and deducted. These limitations are discussed in the chapters on deductions. While the language of the ruling refers particularly to corporations, there seems to be no reason why it should not be applicable to individuals as well.

Same Basis Must Be Used Consistently. Where a taxpayer adopts a system of reporting according to his books, he must report consistently on this basis. He may not claim a right to report on the cash basis in part and the accrual basis in part. The two systems cannot overlap.[44]

Accrued Charges. Under this provision, it is permissible for a corporation which accrues on its books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, to deduct the amount so accrued, provided the accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and income from fixed and determinable sources accruing to the corporation is returned on the same basis.[45]

44 Maryland Casualty Company v. U. S. (Ct. Cls.) T. D. 2451.
45 T. D. 2433.

CHAPTER 17

INCOME FROM PERSONAL SERVICES

The law expressly provides that the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and *in whatever form paid,* or from professions or vocations. It is to be noted that salaries, wages, or compensation for personal services are taxable income "in whatever form paid." This is one of the two cases in which the law expressly specifies that the tax shall be based upon payments other than in cash, the other being the provision relating to stock dividends. Payment of salaries, wages, etc. in the form of living quarters, board or lodging, is referred to in the preceding chapter under the head of income received in the equivalent of cash.

Salaries. Salaries should be reported in the year in which they are received and not in the year in which earned, unless also received in that year. Where a part of the compensation of an employee is in the form of a salary payable monthly, and a part in the form of a bonus not fixed and determined until on or after January 1, of the year following that in which the services were rendered, the fixed salary should be reported in the year in which it is received and the bonus should not be reported until return is made for the year in which that is received. Thus, one receiving a bonus in January, 1918,

for services rendered in 1917, should not report the amount of bonus as income until he files his return on or before March 1, 1919. A salary paid by a corporation which is itself exempt from the income tax is nevertheless subject to tax in the hands of the employee.[1] In the case of corporations, so-called "salaries" of stockholders, if based on the amount of stock held, are considered to be distribution of the net profits of the corporation, not deductible as a business expense of the corporation, and, therefore, not subject to the normal tax in the hands of the recipient.[2]

Bonuses and Profit Sharing. Where employees receive bonuses, or are entitled to a share of the profits of the employer the amount so received should be included as income, provided the same is paid under a contract, express or implied, or a long time practice, regularly employed, which constitutes a condition, if not a contract, under which the employees may reasonably expect additional pay for the greater or better services which they render. Such payments are income to the employee if they are of such character that the employer is entitled to deduct the same as an expense of doing business. If the bonus is a mere gift, the employer having the right to pay or not pay as it suits his pleasure, the employee should not treat the amount as income, since gifts or gratuities are not taxable, and the employer is not entitled to deduct the amount from his income as an expense of doing business. The rules governing the deduction of bonuses and profit sharing payments are more fully treated under the heading of

1 T. D. 2135, T. D. 2090.

2 This point is more fully discussed under the head of deductions in Chapter 28.

deductions, which should be read in this connection.[3] The rule to be followed by the employee is that if the employer is entitled to deduct the amount as an expense of doing business, the employee should return the amount as income, and, *vice versa*, if the employer is not entitled to deduct the amount as expense, the employee should not return the amount as income, otherwise the same sum of income would be taxed twice. If so-called bonuses or profit sharing are paid to stockholders of corporations, which are in fact distributions of net profits based on stock holding, they will be considered as dividends and held to be taxable as such.

Salaries of Partners. As a general rule members of a general partnership are not entitled to salaries, and the Treasury Department will not recognize the payment of salary to a partner unless such salary is provided for in the articles of partnership or by express contract. The question is not of very great importance under the income tax law as partnerships are not taxed as entities, but assumes importance under the excess profits tax law.

Voluntary Offerings Received by Clergymen. Although as a general rule gifts and gratuities are not income, yet Easter offerings, and fees received by clergymen for funerals, masses, marriages, baptisms, etc. are considered income, because though in the form of gifts they are in fact payment to the clergymen for services rendered. Christmas gifts to clergymen do not come within this category.[4] The rule to be observed is whether or not the money is actually a gift or merely in the form of a gift.

[3] See Chapter 28.
[4] T. D. 2090.

Commissions. Commissions paid to salesmen are income, which should be accounted for in the return of the person receiving the same in the year in which received.[5]

Compensation for Services Extending Over a Year. When money in payment of services extending over a year is received at the close of the period all of it becomes income for the year in which it is received. Thus, if no determination has been made of the amount due the trustee of an estate, as compensation for his services over a period of years, until the trust is terminated, the amount allowed him should be returned in full as income for that year, and it should not be pro-rated over the length of time the services were rendered.[6]

Compensation to Federal Government Officers and Employees. Compensation received by Federal officers and employees is subject to tax whether paid in cash or in other forms. The entire sum received, however, is not necessarily taxable as will be indicated in the following paragraphs.[6a]

LIVING QUARTERS. Commutation of quarters and the money equivalent to quarters furnished in kind should be returned as income. When quarters are furnished in kind of a less number of rooms than the number allowed by law, the money equivalent only of the number of rooms actually assigned should be returned as income. When quarters are furnished of a greater number of rooms than the number allowed by law, it is to be assumed that the excess number is assigned for the conven-

[5] T. D. 2090.
[6] T. D. 2135.
[6a] See T. D. 2079.

ience of the Government, and the money equivalent only of the number of rooms allowed by law should be returned as income.

Heat and Light. Amounts received by, or paid for, an officer for heat and light should be returned as income. This includes the money equivalent, as fixed by the Government, of heat and light furnished to an officer occupying public quarters. Amounts expended for heat and light are in the nature of personal living expenses and differ in this respect from amounts furnished for mileage, the latter being in the nature of a business expense or an expense of the employer rather than of the employee.

Mileage. Mileage, as such, is not income to an officer or employee, as he is required to pay his actual expenses while traveling under mileage orders. The difference between the amount received as mileage and the amount of actual necessary expenses incurred on a journey should, however, be returned as income. The actual expenses to be deducted by the individual before ascertaining his income on account of mileage are the expenses for which reimbursement would be made by the Government if he had traveled on an actual expense basis instead of a mileage basis.

Reimbursement for Actual Expenses. Amounts paid by the Government in the nature of reimbursement for subsistence and other items of actual expense incurred while absent on business for the Government are not required to be returned as income.

Per Diem Allowances. Per diem allowances in lieu of subsistence while traveling under orders are not in-

come except to the extent that the per diem allowance exceeds the amount of actual necessary expenses incurred while so traveling.

Compensation of Officers and Employees of a State or Political Subdivision Thereof. The compensation of all officers and employees of a state, or any political subdivision thereof, is exempt from tax,[7] except when the compensation is paid by the United States Government.[8] This exemption applies to officers and employees of the state and of its counties, municipalities, townships and other political subdivisions. The salaries of public school teachers come within this class.[9] The exemption does not include an individual who enters into a contract with a state for the construction of public works, as such person is neither an officer nor an employee.[10] It has also been ruled that where a real estate corporation is employed by a city to appraise the value of property, it cannot claim exemption as an employee. Officials of the governments of the District of Columbia, Porto Rico and the Philippine Islands, or the political subdivisions thereof, do not come within this class and the compensation paid to them is not exempt.[11] It seems, also that the officers and employees of a Territory, or any political subdivision thereof, are not entitled to this exemption, since the law does not include them and there is not the same constitutional objection to taxing them as exists in the case of State employees.

7 This exemption rests on the theory that Congress has no power, even by an act taxing all incomes, to levy a tax on salaries of state officers. See Collector v. Day, 11 Wall. 113.

8 Act of September 8, 1916, § 4.

9 Reg. 33, Art. 5.

10 T. D. 2152.

11 Act of September 8, 1916, § 23.

Compensation of Federal Judges. The salaries of Judges of the Supreme Court and inferior courts of the United States, in office at the time the law was passed, are exempt from the tax, but this does not include the salaries of such judges as have been appointed subsequent to the passage of the law or of judges who have been retired.[12]

Compensation of the President of the United States. The compensation of the President of the United States in office at the time the law was passed is exempt from the tax during the term for which he was elected.[13]

Professions and Vocations. Incomes from professions and vocations are taxable as is income from any other source. No rulings are specially applicable to these forms of income. Such income is taxable in the year in which it is received, not necessarily for the year in which it is earned. Rulings as to this point are general and are discussed in the preceding chapter.

12 Act of September 8, 1916, § 4; T. D. 2090. This exemption was inserted in view of the provision of the Federal Constitution, Art. 3, § 1, which guarantees that the compensation of Federal judges shall not be diminished during their continuance in office. See Opinion of Justice Field in Pollock v. Farmers Loan & Trust Company, 157 U. S. 429; and 13 Op. Atty. Gen. 161.

13 Act of September 8, 1916, § 4. In an opinion of the Attorney General in 1869 it was held that a specific tax by the United States upon the salary of the President in office at the time the act was passed, to be deducted from the salary which otherwise would be paid him, would be a diminution of his compensation in contravention of Article 2, Section 1, Clause 7, of the Federal Constitution, which provides that the compensation of the President shall neither be increased or diminished during the period for which he shall have been elected. 13 Op. Atty. Gen. 162. This consideration no doubt moved Congress to grant the exemption in the present law.

CHAPTER 18

INCOME FROM BUSINESS, TRADE OR COMMERCE

Income from this source is, as indicated in the title, the income derived by an individual or a corporation from business, trade or commerce in which he or it is engaged. With respect to this class of income the phrase gross income has a meaning which differs from that of gross receipts as indicated in the following paragraphs.

Gross Income in Manufacturing Businesses. The gross income of a manufacturing business consists of total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished or unfinished products, raw material, etc., at the beginning and end of the year.[1] A manufacturer may include as an element of the cost of manufactured products, the cost of the raw material, the cost of labor of the men who actually work on such products, as well as the cost of supervisory, or what may be denominated as "unproductive" labor, such as that of the foreman, inspectors, overseers, etc., provided such expenditures are not separately deducted from gross income in the return of annual net income.[2]

Gross Income in Mercantile Businesses. The gross income of a mercantile business should include the total

1 Reg. 33, Art. 104.
2 T. D. 2152.

merchandise sales during the year, increased or decreased by the gain or loss as shown by the inventories of merchandise at the beginning and end of the year for which the return is made.[3]

Inventory. Where, in order to arrive at the correct amount of income, it is necessary that an inventory, or its equivalent, of materials, supplies, and merchandise on hand for use or sale at the close of each year shall be made in order to determine the gross income or to determine the expense of operation, a physical inventory is at all times preferred by the Treasury Department. Where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be accepted. An equivalent inventory is an inventory of materials, supplies, and merchandise on hand taken from the books of the taxpayer.[4] The Treasury Department requires inventories to be taken at the cost price.[5]

Gross Income of Insurance Companies. Special rules are applicable to ascertaining the gross income of insurance companies. These rules are discussed in the chapter on insurance companies.[6]

Gross Income Generally. The gross income of the taxpayer is, generally speaking, his total income derived from the operation and management of his or its busi-

[3] Reg. 33, Art. 105.

[4] Reg. 33, Art. 161.

[5] Although the Department is positive in its stand on this point, it seems to have issued no express ruling or regulation, the only express reference to the requirement that inventory be taken at cost being in the instructions on the back of the form of return of net income of corporations. See Form 1031.

[6] See Chapter 13.

ness and property, together with all amounts of income from all other sources. It embraces, of course, not only the income of a manufacturer or dealer from his business, but also income from all other sources such as rentals, royalties, interest, dividends, and profits from the sale of assets.[7]

Income of Contracting Companies. Where a contracting company has contracts which may run for a period of several years, it may prepare its return in such manner that its gross income will be arrived at on the basis of completed work; that is to say, on jobs which have been finally completed and payments made during the year. If the gross income is arrived at by this method, the deductions from gross income should be limited to the expenditures made on account of such completed contracts.[8]

Income from Export Business. Income from the business of exporting goods is held to be taxable by the Treasury Department. It has also been held that a tax on such income is not a tax on the articles exported, and therefore not unconstitutional in that regard.[9]

Accounts Receivable. Accounts and bills receivable of a business concern are treated by the Treasury Department as income for the year in which they are created; that is, in the year in which the accounts

[7] Reg. 33, Arts. 106 and 107.

[8] T. D. 2161.

[9] Peck v. Lowe, 234 Fed. 125. It was so held by the District Court in which the case was first decided. At the present time the case is before the Supreme Court on appeal.

are set up on the books or the bills receivable are accepted.[10]

Goods Sold on Approval. Where goods are sold on approval, the purchaser paying the full price at the time of sale, but having the privilege of returning the goods within a certain period, the amount received upon the sale should be included as income. Subsequently if the goods are returned and the purchase price refunded the refund may be deducted as a loss or the sum may be treated as a "purchase during the year" by the seller. This procedure would seem to be proper in any case where the transaction is in the course of the taxpayer's business or trade. Where, however, an individual sells property in a transaction not connected with his business or trade, with the privilege on the part of the buyer of returning the property within a certain period and receiving back the purchase price, the transaction should not be considered as closed and completed until the period during which the property may be returned has expired. Otherwise if the taxpayer includes the profit on such transaction in his income for the year he may not be able to avail himself of the loss of that profit if the refund takes place in a subsequent year, since the loss can be offset only against gains in similar transactions during the latter year. The proper method of handling such transactions would seem to be to hold the payment "in suspense" until the title has passed without condition from the seller to the buyer, and to enter the profit on the transaction as income for the year in which that takes place.

10 Letter from Treasury Department dated March 2, 1915; I. T. S. 1917, ¶ 1183.

Payments by Instalment. If payments for goods sold are made in instalments by the buyer, a proportionate part of each instalment represents the profit on the sale of the goods and the rest represents a return of capital to the seller. The manner of treating the income arising on the payment on such instalments is described in a later chapter.[11]

Income from Business of Certain Public Utilities May Be Exempt. The law expressly exempts from tax any income derived from any public utility or from the exercise of any essential governmental function accruing to any state, territory or the District of Columbia or any political subdivision of a state or territory. It further provides that whenever any state, territory or the District of Columbia or any political subdivision of a state or territory has, prior to the passage of the law, entered in good faith into a contract with any person or corporation, the object and purpose of which is to acquire, construct, operate or maintain a public utility, no tax shall be levied upon the income derived from the operation of such public utility so far as the payment thereof will impose a loss or burden upon such state, territory, district or political subdivision, but this does not confer upon any person or corporation any financial gain or exemption or relieve any such person or corporation from the payment of a tax as provided for in the law upon that part or portion of such income to which such person or corporation is entitled under the contract.[12]

[11] See Chapter 26.

[12] Act of September 8, 1916, § 11 (b).

Income from Partnerships. The net income of a partnership from business, trade and commerce and from all other sources is returned by the partners under the foregoing general rules and the special rules discussed in the chapter on partnerships.[13]

[13] See Chapter 10.

CHAPTER 19

INCOME FROM FARMING

Special rules have been made with respect to farms and farmers.[1] In connection therewith the term "farm" is defined as embracing the farm in the ordinary accepted sense, plantations, ranges, stock farms, poultry farms, dairy farms, fruit farms, truck farms, and all lands used for similar purposes; and the term "farmers" is defined as all persons who cultivate and operate or manage farms for gain or profit, either as owners or tenants.

"**Gentlemen Farmers.**" A person cultivating or operating a farm for recreation or pleasure, on a basis other than the recognized principles of commercial farming, the result of which is a continual loss from year to year, is not regarded as a farmer. In such cases, if the operation of a farm results in a net gain for the year, such gain must be included. If, however, the expenses and losses incurred in connection with the farm are in excess of the receipts the entire receipts from the sale of products may be omitted from the return of income; and the expenses, being regarded as personal expenses, will not be allowed as a deduction from income derived from other sources.

Farmers Keeping Books. Farmers who keep books, according to some approved method of accounting,

[1] T. D. 2153.

which clearly show the net income, are permitted to prepare their returns from such books although the method of accounting may not strictly be in accordance with the rules which are laid down for farmers who do not keep books.

Income from Sale of Farm Products. All gains, profits and income derived from the sale or exchange of farm products, whether produced on a farm or purchased and resold by the farmer, must be reported as income for the year in which the products were actually marketed and sold, or exchanged for money or a money equivalent.

Income from Rents Received in Kind. Rents received in crop shares are to be reported as income in the year in which the crop shares are reduced to money or a money equivalent.

Deductions. Farmers may deduct all legitimate expenses incident to the production of the year, or future years, although the products to which such expenses and deductions are incidental may not have been sold. Where farm products are held for favorable market prices, no deduction on account of shrinkage in weight or physical value, or losses by reason of such shrinkage or deterioration in storage, are allowed. The cost of stock purchased for resale may at the option of the farmer be deducted as an expense or taken into consideration upon the sale of such stock. Money expended for stock for breeding purposes may not be deducted as an expense, but is regarded as capital invested. Where stock, which has been purchased for any purpose, dies from disease or injury, or is killed by order of state or federal authori-

ties, and the cost thereof has not been claimed as an item of expense, the actual purchase price of such stock, less any depreciation which may have been claimed, may be deducted as a loss. Property destroyed by order of state or federal authorities may be claimed as a loss. If reimbursement is made by the state or federal authorities, in whole or in part, on account of the destruction of stock or property, the amount so received is to be reported as income. The cost of ordinary tools may be deducted as an expense, but not the cost of farm machinery. Depreciation may be claimed on farm machinery and on farm buildings (except the dwelling occupied by the owner) and other physical property, including stock purchased for breeding purposes. No claim for depreciation will be allowed on stock raised or purchased for resale, as the cost thereof may either be deducted as an expense or taken into account at the time the stock is sold. These deductions are discussed in detail in the several chapters on deductions.[2]

[2] See Chapters 20 to 32, inclusive.

CHAPTER 20

INCOME FROM SALES OR DEALINGS IN PROPERTY

The law expressly provides that gains, profits and income derived from sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, shall be taxable.[1] It has been argued that gains resulting from an increase in capital should not be taxed, in cases where an owner was not engaged in the business of dealing in such property, but the language of the law is broad enough to cover all transactions whether or not the taxpayer is a dealer. The case of Gray v. Darlington[2] construing the income tax act of 1864 held that the gain to an individual resulting from the sale of property, purchased by him several years before, was not taxable, on the theory that the increased value of the property could not be said to be gain in any particular year of the time during which it was held. It has been argued that the rule laid down in this case should be applied to the present law, but a comparison of the statute under which the case was decided with the 1913 and 1916 Laws leads to the conclusion, on the part of the author, that the case has no application to the language of the later

1 Act of September 8, 1916, § 2 (a).
2 15 Wall. 63; 21 L. Ed. 45.

statutes.[3] The intent of the 1913 Law and the 1916 Law seems clearly to be that gains from sales or dealings in property, regardless of whether the property is sold in the course of a business or trade or otherwise, shall be taxed. It has been held by the Treasury Department that gains and profits resulting from a sale of property are subject to tax.[4] The gain, profit or income is the amount by which the selling price exceeds the cost. Book values are ignored where they do not represent the actual cost of the properties. The entire profit is taxable unless the property was acquired prior to the incidence of the tax.[5]

Cost of Property. The cost of property is the actual price paid for it at the time of purchase, together with the expense of procuring it and the expense of selling it. If improvements or betterments have been made the cost of such improvements or betterments may also be added to the cost of the property.[6] It is also permissible to add to the initial cost of the property such carrying charges as interest, taxes, insurance, etc., provided such carrying charges have not been deducted

[3] Under the 1909 Law, it was held that the profit from the sale of stock purchased in 1902 and sold in 1911 was not income to any extent whatever, the court following the case of Gray v. Darlington. Gauley Mountain Coal Company v. Hays, 230 Fed. 110. The Darlington case was also followed in Industrial Trust Company v. Walsh, 222 Fed. 437, in holding that an increase in the book value of property did not constitute income under the 1909 Law. Other cases held the profit taxable. The case of Gray v. Darlington is more fully discussed in Chapter 43 on the constitutionality of the present law.

[4] T. D. 2090; T. D. 2137.

[5] T. D. 2090; letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 262.

[6] T. D. 2090.

from net income in any annual return of the owner subsequent to the income tax.[7]

PROFIT NOT BASED ON BOOK VALUES. The value at which property is carried on the books of the owner is not conclusive evidence of its actual value. Where the Government attempts to impose a tax upon the difference between the book value and selling price, the taxpayer may show by other evidence the actual cost thereof or the actual value at the incidence of the tax.[8]

SHARES OF SAME STOCK BOUGHT AT DIFFERENT PRICES. When various parcels of stock of the same issue are bought and sold on different dates and at different prices, the shares sold should be identified, if possible, by the numbers of the certificates covering them, and the cost of the identical shares should be deducted in order to determine the profit. Where it is impossible to identify the shares in this manner, the shares should be considered to be sold in the order in which they were purchased, that is, the cost of the first shares purchased should be deducted from the selling price of the first shares sold.[9]

PROPERTY ACQUIRED BY A CORPORATION FOR STOCK. In cases where property was taken over by a corporation in exchange for its capital stock, at a par value greatly in excess of the true value of the property, and such property is later sold, it has been held by the Treasury Department that it will be necessary to ascer-

7 T. D. 2137.

8 U. S. v. Guggenheim Exploration Company, 238 Fed. 231.

9 Letter from Treasury Department dated February 26, 1916; I. T. S. 1917, ¶ 280.

tain as nearly as possible the true value of the property at the time it was taken over, and any excess over this ascertained value is income. Similarly, it has been ruled that where corporations have acquired for a mere nominal sum, property which at the time of its acquirement had a value greatly in excess of such sum, a careful estimate of the value of the property at the time it was acquired may be fixed and set up as the value representing the cost of the property, and any excess over such fixed value, at which such property may thereafter be disposed of, will be treated as income. The value of property so fixed is subject to the approval of the Internal Revenue Bureau.[10]

RULE AS TO FARMERS. The cost of stock purchased for resale may be deducted by a farmer under the item of expense in the year in which the stock is purchased.[11] This, however, is not an absolute requirement, since a farmer may purchase stock to such an extent that the cost would more than offset his income for the year. He may therefore treat the amount paid for stock in the same manner as the cost of any other property, that is, make no deduction at the time of purchase, but deduct such cost from the selling price at the time of sale and report only the remainder as profit. Money expended for stock for breeding purposes is regarded as capital invested and such sums may not be deducted as expense in the year in which the stock is purchased. The amount so paid for stock for breeding purposes may be taken into consideration under the head of depreciation, that is, the total sum paid may be divided by the number of years in which

10 T. D. 2161.
11 T. D. 2153.

the stock is expected to live, or be useful for the purposes for which bought, and the resulting sum may be deducted from each year's income. Should such stock be sold at any time, the cost thereof, less the aggregate amount which has been so claimed as depreciation, may be deducted from the selling price, the remainder, if any, constituting income.

PROPERTY LEFT BY A DECEDENT. When an individual dies after March 1, 1913, leaving property, all gains or losses on subsequent sales should be computed on the basis of the appraised value of the property at the date of death of the former owner. Neither the executors nor anyone acquiring the property of the decedent is required to make a return of the book gains or losses up to the date of death. If the executors should sell the property the difference between the appraised value at the date of death and the selling price constitutes the taxable profit. If the property is transferred to a beneficiary of the estate no income accrues to the beneficiary as a result thereof, since the value of property acquired by gift, bequest, devise or descent is exempt from tax. Any income which the beneficiary thereafter derives from such property is taxable and, if such property is sold, the difference between the appraised value of the property at the date of decedent's death and the selling price constitutes the taxable profit.[12] In cases where an individual died prior to March 1, 1913, the value on March 1, 1913, of any property left by the decedent is the amount to be used as a basis for computing the taxable profit in any subsequent sale by the executors or the beneficiaries.

[12] Telegram from Treasury Department dated February 3, 1917; I. T. S. 1917, ¶ 1999.

Property Acquired Before March 1, 1913. The 1916 Law provides that for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived or loss sustained.[13] This provision applies in all cases of individuals and corporations. In all such cases the original cost of the property is disregarded and the value as of March 1, 1913, is taken, whether or not such value is more or less than the original cost.[14] Under the 1909 and 1913 Laws it was the practise of the Department to require the taxable profit to be determined by first ascertaining the difference between the cost and the selling price and then pro-rating the result according to the number of months the property was held before and after the incidence of the tax, but this rule has no application under the present laws.

MARKET VALUE OF SECURITIES ON MARCH 1, 1913. Where stock, acquired prior to March 1, 1913, is sold, and such stock was traded in on an exchange, the fair

13 Act of September 8, 1916, § 2 (c), § 5 (a), § 6 (a), § 10.

14 This provision first appeared in the 1916 Law, no reference being made in the 1909 Law or the 1913 Law as to assets acquired prior to the incidence of the tax. In one case under the 1909 Law it was held that profit on the sale of property purchased prior to January 1, 1909, and sold thereafter was income only to the extent that the selling price exceeded the ascertained market value on January 1, 1909. (Cleveland, etc., Railway Company v. U. S., 242, Fed. 18.) In another case it was held that where the assets were acquired for the purpose of sale, the inventory value at the time of the incidence of the tax should be the basis. (Doyle v. Mitchell, 235 Fed. 686; 149 C. C. A 106.)

market price or value as of March 1 is held to be the average price for the day in cases where there is a variation between the opening and closing price.[15]

Special Rule in Case of Book Values Reported Under 1909 Law. Under the provisions of the 1909 Law the Treasury Department permitted income to be computed on the basis of changes in book values. Hence, where a corporation for the years 1909 to 1912 inclusive, made its returns strictly in accord with the regulations then in force, the increase of book values of property being returned as income and corresponding decreases being deducted, as the regulations then required and permitted, the profit on such property could be computed under the 1913 Law by deducting the amount of the last adjusted value subsequent to January 1, 1909, without pro-rating as required in other cases.[16] This ruling has no application under the 1916 Law, which expressly requires, in all cases, that the gain be based on the value as of March 1, 1913, regardless of any book values prior thereto.

Selling Price. The selling price is the amount received for the property. It may be held to be taxable whether received in cash or in the equivalent of cash. For a discussion of income received in the equivalent of cash, see chapter on income in general.[17]

15 Letter from Treasury Department, dated November 21, 1916; I. T. S. 1917, ¶ 273.

16 T. D. 2130.

17 See Chapter 16.

CHAPTER 21

INCOME FROM RENT

Rent is returnable as income in the year in which it is received, and not necessarily in the year in which it becomes due. Thus, where a tenant pays part of his rent for the preceding year on the second day of January of the following year, the amount so paid is income to the landlord for the year in which it is received, and not the year which it covers.[1] This rule, however, is not absolute, as the landlord may, if he keeps his books accordingly, report the rent for the year in which the income accrues and charge against it the deductions for the same period.

Value of Improvements Made by Tenant. Where, under the terms of a rental or lease contract, a tenant agrees to erect a building or to expend during the rental period a certain fixed sum in making improvements upon the freehold of the lessor, it is held for income tax purposes that the building or permanent improvement becomes a part of the realty unless otherwise agreed between the contracting parties; and, as such, must be accounted for as gain or profit to the lessor at the time the lease is terminated, whether terminated by expiration or otherwise. The amount

[1] Letter from Treasury Department dated February 9, 1915; I. T. S. 1917, ¶ 226.

of the gain or profit to the lessor at the termination of the lease is the difference between the cost of the building or improvement so made by the tenant and a reasonable allowance for depreciation during the period of its life under the lease.[2]

Lessor Corporations. Where a corporation leases all of its property to another and specifies that the consideration therefor shall be paid direct to its stockholders and bondholders or creditors the lessor corporation is, nevertheless, held to be the proper recipient of the income and must report, as rent, the amount so paid to its stockholders, bondholders or creditors by the lessee.[3]

Payments by Tenant on Behalf of Landlord. Where under the terms of a lease a tenant pays taxes or interest, or makes any other payments for and on behalf of the landlord, the amount of such payments constitutes income to the landlord and should be reported by him as such. The theory covering these transactions is that the tenant is acting merely as agent for the landlord in making such payments. The expenses are the landlord's, which he may deduct from his net income, and the amounts used to defray such expenses must be included by the landlord as his net income. Such payments may be deducted by the tenant as rent in the year in which they are paid.

[2] T. D. 2442. It necessarily follows that the tenant may consider the cost of the building as a part of his rental payments and may deduct such amount as an expense, pro-rating the original cost over the number of years constituting the term of the lease. See Chapter 28.

[3] For a further discussion of this subject see sub-heading entitled Lessor and Lessee Corporations in Chapter 12.

Receipt of Rent in Kind. Where rent is received in the form of produce, as for instance, a share of the crops of a farm, the amount realized on the sale of such share must be included as income in the year in which the share is disposed of or reduced to money or its equivalent. Where board or lodging is given as the equivalent of rent, the value of such board or lodging is required to be included.[4]

[4] See Chapter 16 for statement on receipt of income in kind or in the equivalent of cash.

CHAPTER 22

INCOME FROM INTEREST

Income derived in the form of interest is taxable in the hands of citizens and residents and domestic corporations, whether received from debtors in this country or debtors in foreign countries. Interest is taxable in the hands of non-resident aliens and foreign corporations when derived from interest bearing-obligations of residents, corporate or otherwise.[1]

Interest Exempt from Tax. The Act expressly provides that interest upon the obligations of a state, or any political subdivision thereof, or upon the obligations of the United States (with certain exceptions noted below), or its possessions, or securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916, shall be exempt.

INTEREST ON OBLIGATIONS OF THE UNITED STATES. The interest received on obligations of the United States is exempt in the case of all obligations issued on or before September 1, 1917. In the case of obligations issued after that date the interest is exempt only if and to the extent provided in the Act authorizing the issue thereof.[2]

[1] Act of September 8, 1916, § 1 (a).

[2] Under earlier income tax laws interest upon the obligations of the United States was expressly included as taxable income. (See Act of March 2, 1867). Under the 1909 Law the Attorney

SECOND LIBERTY LOAN BONDS. The Act authorizing the issue of the Second Liberty Loan Bonds provides [3] that the bonds and certificates issued thereunder "shall be exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, or any State, or any of the possessions of the United States, or by any local taxing authority, except (a) state or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations. The interest on an amount of such bonds and certificates, the principal of which does not exceed in the aggregate $5,000, owned by any individual, partnership, association, or corporation, shall be exempt from the taxes provided for in Subdivision (b) of this section." It will be noted that bonds of this issue are not subject to the normal tax nor to the income tax of 6% if held by corporations. Where a husband and wife each own in his or her own right bonds of this issue not exceeding $5,000, each is entitled to exclude the income therefrom in computing the tax on their joint incomes. Minor children having separate estates are also each entitled to the same exemption.[4] A taxpayer holding bonds and certificates of indebtedness issued under this Act is en-

General held that interest on National Bonds should be included as income of corporations, since the tax was not a tax on property, but a tax on the privilege of carrying on business. (28 Op. Atty. Gen. 138).

[3] Act of September 24, 1917 (Public No. 43), § 7.

[4] Letter from Treasury Department dated October 8, 1917; I. T. S. 1917, ¶ 2439.

titled to the exemption on $5,000 of his aggregate holdings, not on $5,000 of each class of obligations.[4a]

Obligations of the Possessions of the United States. Interest paid on the obligations of possessions of the United States is exempt. Interest on the obligations of the territories, or political subdivisions thereof, can be considered as exempt only on the ground that the territories are possessions of the United States, since the law does not expressly include territories in the exemption provision.

Interest on the Obligations of a State. The same principle which denies to a state power to raise revenue by taxation on federal property, or sources of revenue, or means of carrying on its duties, forbids taxation of state revenue for federal purposes.[5] Therefore the United States has no power under the Constitution to tax either the instrumentalities or the property of a state.[6] A municipal corporation is a portion of a sovereign power of a state and is not subject to taxation by Congress upon its municipal revenue.[7] But the exemption of state agencies does not extend to those used by the state in carrying on an ordinary private business.[8] Interest on the obligations of a state is, therefore, expressly exempt. The 1909 Law, however, being an excise tax and not an income tax, was valid although measured by income which included interest from state securities.[9]

4a T.D. 2585.

5 Collector v. Day, 11 Wall. 113; Ambrosini v. U. S. 187 U. S. 1.

6 Pollock v. Trust Company, 157 U. S. 429, 584.

7 U. S. v. Railroad Company, 17 Wall. 322.

8 South Carolina v. U. S. 199, U. S. 437.

9 Flint v. Stone Tracy Co., 220 U. S. 107.

POLITICAL SUBDIVISION OF A STATE. Difficulty is sometimes encountered in determining whether bonds issued by districts or divisions of a state are exempt under this phrase. The Attorney General has held that special assessment districts created for a public purpose, such as the improvement of streets and public highways, the provision of sewage, gas and light and the reclamation, drainage, or irrigation of land are districts for public use, and consequently political subdivisions of the state, within the meaning of the law.[10] Levee and school districts lawfully created and authorized by the state to levy a tax to meet the obligations of such district are also held to be political subdivisions of the state. In general the term "political subdivision" includes special assessment districts or divisions created by proper authority of the state acting within its constitutional powers and under its general laws, for the purpose of carrying out a portion of those functions of the state which by long usuage and inherent necessities of government have always been regarded as public.[11]

MORTAGE ASSUMED BY MUNICIPALITY. Although interest on municipal bonds are exempt from the tax, yet where a municipality has purchased a public utility sub-

10 Opinion of Attorney General dated January 30, 1914. In the course of his opinion the Attorney General said: " * * * where the power to levy a tax is given a district by the state, presumptively that district is created for a public use, and is exercising a public function. * * * Nor does it make any difference that the tax is measured by the benefit conferred." But he refrained from expressing any opinion whether assessment districts might not be created for a purely private purpose so as to bring them within the principles laid down in the South Carolina Dispensary case, 199 U. S. 437, rather than within those which governed U. S. v. Railroad Company, 17 Wall. 322.

11 T. D. 1946.

ject to a mortgage, and the mortgage retains its original character, even though the municipality assumes the mortgage indebtedness and pays the interest thereon, the mortgage does not become an obligation of the municipality within the meaning of the law and the interest thereon is not exempt.[12]

Interest on Bonds of Exempt Organizations. Although a corporation may under Sec. 11 of the 1916 Law be exempt from a tax on its income, yet interest on the bonds of such an organization is taxable income to the bondholder.[13]

Accrued Interest on Obligations at Time of Purchase. Where a purchaser pays the price of the security purchased and an additional sum representing accrued interest, the amount of interest received on the next interest date should not be reported in full. The amount of accrued interest at the time of purchase represents the return of capital to the purchaser and he should deduct such amount from the interest received, and report the remainder only. The seller of the security should account in his return for the accrued interest received at the time of sale, since to him that amount is income.[14]

12 T. D. 2090.

13 Letter from Treasury Department dated July 30, 1914; I. T. S. 1917, ¶ 1222.

14 Letter from Treasury Department dated February 5, 1915; I T. S. 1917, ¶ 232. In a later ruling the Treasury Department declined to permit the taxpayer in such a case to report all of the interest received as income and to deduct the amount of accrued interest paid at the time of purchase as an expense or as interest paid by the purchaser. Letter dated March 8, 1915, I. T. S. 1917, ¶ 237.

Interest on Bank Deposits. Interest on bank deposits or on certificates of deposit, credited to the account of the depositor by the bank, is income for the year in which the credit is made.[15]

Interest Received and Paid by Brokers. Where the customers of a brokerage house buy securities, paying only a part of the purchase price and paying interest on the balance, and the brokerage house buys such securities from others, paying only a part of the purchase price and paying interest on the balance, the brokerage house must include in its return as gross income the interest received from the customers and may deduct as interest the amount of interest it pays on such purchases limited, in the case of corporations, to the amount of interest which may be deducted under the law.[16]

Interest Accruing Prior to March 1, 1913. Where interest became due prior to March 1, 1913, and funds have been on hand to pay the same since the due date the amount is not taxable, since it represents income that was due and payable and could have been reduced to possession on demand prior to the incidence of the income tax. Even where interest has been in default since a time prior to March 1, 1913, and funds to pay the same have accrued since that date, it has been held that the interest represents income accrued to the owners of the bonds prior to the incidence of the tax, and hence

15 Reg. 33, Art. 67; Letter from Treasury Department dated February 18, 1915; I. T. S. 1917, ¶ 240.

16 Altheimer and Rawlings Investment Co. v. Allen; T. D. 2441. This case was decided under the 1909 Law but the principle seems to apply to the language of the present law. Interest would be deducted in full if paid on collateral the subject of sale in the ordinary course of business.

does not constitute taxable income when received thereafter.[17]

[17] Letter from Collector at Cincinnati dated March 16, 1915, embodying decision of the Treasury Department; I. T. S. 1917, ¶ 332.

CHAPTER 23

INCOME FROM DIVIDENDS

The law expressly states that the net income of a taxpayer shall include gains, profits and income derived from dividends.[1]

Definition. The term "dividends" as used in the law is defined therein to mean any distribution made or ordered to be made by a corporation, joint stock company, association, or insurance company, out of its earnings or profits accrued since March 1st, 1913, and payable to its shareholders, whether in cash or in stock of the corporation.[2] It is to be noted that under this definition any distribution which is made or ordered to be made by a corporation is a dividend. It need not necessarily be called a dividend or be made in the ordinary course of business. A distribution of assets at the time of liquidation of a corporation would be a dividend to the extent that the assets so distributed included earnings or profits accrued since March 1st, 1913. On the other hand, if the distribution is not out of its earnings or profits accrued since March 1st, 1913, it does not become a dividend within the meaning of the law by reason of the fact that it is called a dividend by the corporation making the distribution.

1 Act of September 8, 1916, § 2 (a).

2 Act of September 8, 1916, as amended by Act of October 3, 1917, § 31.

DIVIDENDS ON LIFE INSURANCE POLICIES. It is a custom of insurance companies to return each year a portion of the premium paid by the insured. The amount so returned is usually designated as a "dividend" and is either received in cash by the insured or applied by him to the reduction of the next annual premium. Such "dividends" are not considered taxable income under the law and should not be included in the annual return. Where, however, dividends are received on a paid-up policy the amount must be included and should be considered the same as dividends from corporations,[3] unless, of course, the dividend was not paid by the insurance company out of earnings or profits accrued since the incidence of the tax.

DIVIDENDS FROM ASSOCIATIONS. Since limited partnerships, associations, joint stock companies and insurance companies (whether incorporated or not) are treated as corporations, the net earnings of such organizations should be considered as dividends.[4] Thus private banks, which have the form of corporate organization, are required to make returns as corporations, and the owners of the bank are authorized to treat as dividends the earnings which they receive therefrom.[5] The recipient of profits of associations or limited partnerships should, therefore, ascertain whether the association or partnership is reporting its income as an entity, and in such event should treat the net profits of the association as dividends.

[3] T. D. 2137.

[4] T. D. 2152. See Chapter 12 for definition of the term "corporations."

[5] T. D. 2137.

Extent to Which Dividends Are Taxable. The extent to which a dividend is taxable depends upon the status of the corporation paying the same, and upon the status of the recipient of the dividend.[5a]

Dividends of Domestic Corporations. In the case of dividends declared and paid by a domestic corporation, which is taxable upon its net income under the law, the dividend is not subject to the normal tax if received by an individual. If the individual is a non-resident alien, exemption from the normal tax on such dividends will be allowed only in case he files a return of his total net income, received from all sources in the United States, in the manner prescribed by law. If such dividend is received by a corporation, domestic or foreign, it is subject to the 2% tax imposed by the 1916 Law, but is not subject to the 4% tax imposed by the 1917 Law.

Dividends of Non-Resident Foreign Corporations. Dividends of a non-resident foreign corporation, if paid out of its earnings or profits accrued since March 1st, 1913, are taxable when received by a citizen or resident of this country, and must be reported for the purpose of both the normal tax and the supertaxes. When received by a domestic corporation such dividends are taxed under the 1916 Law and the 1917 Law. Such dividends received by non-resident aliens or foreign corporations are subject to no tax, although the dividend may be paid by the paying agent for such corporation at a place within the United States.

Dividends Paid by Resident Foreign Corporations. When a foreign corporation derives its entire income

[5a] The rate depends upon the year in which the profits were accumulated by the corporation. See p. 267.

from business done wholly within the United States, and pays the income tax upon its entire net income, dividends declared by it should be treated in the same manner as dividends from domestic corporations.[6] It seems, also, that if a foreign corporation pays the income tax on a part of its net income, the dividends it pays should be treated, to that extent, as dividends of domestic corporations are treated. Thus, if a foreign corporation pays the income tax on half of its income, half of its dividends should be free from normal tax when paid to individuals, and from the 1917 tax when paid to corporations.

DIVIDENDS RECEIVED BY CITIZENS AND RESIDENTS. When dividends are received by individuals who are citizens or residents of this country, they must be included in the return of annual net income; but for the purpose of assessing the normal tax under each of the present laws, the amount of dividends received from the net earnings of any corporation taxable upon its net income, as indicated in the foregoing paragraphs, may be excluded. For the purpose of assessing the supertaxes under each of the present laws, such dividends must be included. The same rule applies where dividends are received by the estate of a deceased citizen or resident or by a trust estate created by a citizen or resident. The fact that an individual may not have legal title to the stock on which the dividends are declared does not alter the rule, if he is the actual beneficial owner. Therefore, the amount which may be received by a trustee in the form of dividends may be treated as dividends by the beneficiary in making his return; and similarly dividends received by a part-

6 T. D. 2090.

nership are treated as dividends received by the partners, when the partners make their personal returns of their net distributive shares in the profits of the partnership.

Dividends Received by Non-Resident Aliens. A non-resident alien is subject to the normal tax on dividends of domestic corporations, unless he files or causes to be filed a return of annual net income showing his total income received from all sources, corporate or otherwise, in the United States, in the manner prescribed for non-resident aliens. By so doing he is entitled to claim exemption from the normal tax on the amount of dividends received from any corporation taxable upon its net income.[7] Although this exemption from normal tax may be enjoyed by a non-resident alien only by filing a return of annual net income, the normal tax is, nevertheless, not deducted at the source upon payments of dividends to non-resident aliens, since the section of the law providing for deduction at the source expressly declares that it shall not apply to income derived from dividends on capital stock, or from the net earnings of a corporation which is taxable upon its net income.[8] Dividends received by a non-resident alien from the net earnings of foreign corporations are not income from sources within this country, even though the dividend is paid in this country.

Dividends Received by Corporations. With respect to the 2% tax imposed by the 1916 Law, a corporation must include in its taxable income all dividends

7 Act of September 8, 1916, § 6 (c), as amended by Act of October 3, 1917.

8 Act of September 8, 1916, § 9 (b), as amended by Act of October 3, 1917.

received from corporations of which it may be a stockholder, whether the paying corporation is taxable on its net income or not. For the purpose of computing the 4% tax imposed by the 1917 Law, a corporation may exclude the amount it receives as dividends upon the stock of any other corporation, which is taxable upon its net income.[9]

Dividends Received by Nominal Stockholders. When a dividend is received by one who is not the actual owner of the stock, but is the owner of record, he is not required to include the amount in his own income tax return,[10] but should proceed in accordance with the rules stated in the chapter on nominal stockholders.[11]

Dividends on Stock of Federal Reserve Banks. Dividends or income derived from the stock of Federal Reserve Banks is exempt from the tax on the theory that the exemption provided for in the Federal Reserve Act attaches to and follows the dividends into the hands of the member banks holding the Federal Reserve Bank stock.[12]

Dividends from Profits or Surplus of Prior Years. The rate of tax on dividends received in 1917 or subsequent years, depends upon the year in which the amount distributed as dividends was earned by the paying corporation. The law provides expressly that

9 Act of October 3, 1917, Title I. § 4.

10 Letter from Treasury Department dated November 21, 1916; I. T. S. 1917, ¶ 183.

11 See Chapter 7 on Nominal Stockholders.

12 Federal Reserve Bulletin, April 1, 1916.

the dividends shall be a part of the annual income of the distributee for the year in which received, but shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation.[13] The language of this provision is obscure, but it seems to mean, for instance, that if an individual receives a dividend from profits or surplus accumulated by the corporation in 1916, he will add it to the amount of his income reported for 1916 and pay the supertax thereon at the 1916 rates; and similarly with respect to dividends from profits or surplus accumulated in 1915, 1914, or 1913. When such dividends are received by a corporation, the computation is more simple, as there is no graduated tax to be taken into consideration. Thus, a corporation receiving $30,000 in dividends in 1917, $10,000 of which is from surplus earned in each of the years 1914, 1915 and 1916, will pay 1% on $20,000 (the rate for 1914 and 1915) and 2% on $10,000 (the rate for 1916).

Dividends Deemed to Be from Most Recently Accumulated Profits or Surplus. Any distribution made to stockholders in 1917, or thereafter, shall be deemed, under the express provisions of the law, to have been made from the most recently accumulated undivided profits or surplus. This provision would seem to have reference to the profits and surplus in existence at the time of the declaration of the dividend, and not the time of payment. It would seem that a dividend declared in the current year would not be considered to be out of that year's earnings, unless the books of a corporation, at the time the dividend was declared, had been

13 Act of September 8, 1916, § 31, added by Act of October 3, 1917.

closed and showed undivided profits or surplus for the current year. The language used in the law is that the dividends "shall be deemed to have been declared from the most recently accumulated undivided profits or surplus," regardless of what the actual facts may be. Thus, the corporation may actually intend to make a distribution in the form of dividends out of some fund other than the most recently accumulated profits or surplus, but, nevertheless, the law deems such payment to have been made from the most recently accumulated profits and surplus and the dividend will be taxable on that basis. This provision does not apply, however, to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913.[14]

Dividends from Earnings or Profits Accrued Prior to March 1st, 1913. When a dividend is declared from earnings or profits accrued prior to March 1st, 1913, the recipient, whether individual or corporation, is liable for no tax thereon. Such earnings or profits, however, can be distributed only after all of the earnings and profits of the corporation accrued since March 1st, 1913, have first been distributed.[15]

[14] Under the 1916 Law, the Treasury Department ruled that dividends could be declared from any specified fund, that is, a dividend could be declared from surplus accumulated prior to March 1, 1913, and consequently be free from tax in the hands of the stockholders, although the corporation had surplus and undivided profits accumulated since that date sufficient to pay the dividend. This ruling is annulled by the amendment of October 3, 1917, except as indicated in the text.

[15] Act of September 8, 1916, § 31 added by Act of October 3, 1917. There is conflict in the cases under the 1913 Law as to the taxability of dividends distributed subsequent to the incidence of

SUCH DIVIDENDS EXEMPT ONLY TO STOCKHOLDERS OF FIRST CORPORATION. Where dividends are declared from surplus accrued prior to March 1, 1913, they are free from tax in the hands of the stockholder, but if such stockholder is in turn another corporation, upon the distribution to its stockholders of the sum so received as dividends, the fund becomes taxable to the stockholders of the second corporation as, to the holding company, such sum did not represent earnings or profits accrued prior to March 1, 1913. While the law provides for the exemption of dividends from corporate

the tax from earnings which accrued prior thereto, the law being silent on that point. The Circuit Court of Appeals declared in the case of Lynch v. Turrish, 236 Fed. 653, that a sum received by a stockholder in excess of the par value of his stock, exclusively from the increase in value of his stock prior to March 1st, 1913, on account of the gradual advance in the value of the property of the corporation prior to that date, was not income when distributed by the corporation after the incidence of the tax. In a case decided at the same time, Lynch v. Hornby, 236 Fed. 661, the same court held that dividends received by a stockholder from the conversion of property into money and a distribution after the incidence of the tax was not taxable where the dividend represented the value of property owned by the corporation on March 1st, 1913, including the increase of the value of its timber lands and *surplus from its business operations*, the court announcing as its opinion that no property held by the corporation or the stockholder, whether original capital or previously earned surplus income, gains or profits, was intended to be made, or was made, taxable as income by the 1913 law, so far as it represented the value of such property on March 1st, 1913. In a later case, Southern Pacific Company v. Lowe, 238 Fed. 847, the District Court, for the southern district of New York, held that dividends from surplus accumulated prior to March 1st, 1913, were not taxable, if the surplus represented an increase in the value of the assets of the corporation, but were taxable, if the surplus was accumulated from earnings or profits of the corporation prior to the incidence of the tax. The question is now before the United States Supreme Court for final decision.

funds earned prior to March 1, 1913, it does not provide for tracing the identity or character of such dividends after the receipt thereof by the stockholders of the corporation which earned the fund prior to the incidence of the tax.[16]

Dividends Received by an Estate. Dividends received by an estate are not exempt because paid from surplus accrued prior to the creation of the estate, but are taxable as are dividends received by other taxpayers, that is, either to the beneficiaries if the income is distributed, or to the estate if it is not distributed,[17] unless the dividends were declared from earnings or profits which accrued to the corporation prior to March 1, 1913.

Dividends from Reserves for Depreciation or Depletion. It is the practice of some corporations to declare dividends out of reserves set aside to meet depreciation and depletion. Such dividends are held taxable to the stockholders if declared out of reserves accumulated since March 1, 1913.[18]

Cash Dividends. Where a dividend is paid in cash, or by check, which is the equivalent of cash, the dividend becomes taxable to the recipient in the year in which it is received, not necessarily in the year in which it is declared. In such cases it should be reported

16 Letter from Treasury Department dated July 23, 1917; I. T. S. 1917, ¶ 2277.

17 Letter from Treasury Department dated October 19, 1915; I. T. S. 1917, ¶ 669. The priuciple of the decision in Matter of Osborne, 209 A. D. 450 (N. Y.) was referred to in this letter and held to have no application to the income tax law.

18 T. D. 2540.

as income for the year in which the cash or check is received.[19]

Scrip Dividends. When a dividend is paid in scrip it is held to be equivalent to a payment in cash and an investment of the cash in the scrip. The dividend, therefore, must be included in the return at the face value of the scrip.[20] If at a later date the face value of the scrip is not realized in cash a loss may be claimed in the year in which the stockholder parts with the scrip.

Dividends Paid in Equivalent of Cash. Very few rulings have been made on the subject of distribution of the net earnings in property other than cash or stock of the corporation. When distribution is made in property which has no fixed money value, it would be difficult to determine the amount, if any, of earnings or surplus in such distribution. Although the law, in its definition of the term "dividends," expressly states that a dividend shall be a payment in cash or in stock of the corporation, it does not seem to be the intent thereof that no tax shall accrue if the payment is made in the equivalent of cash. Where, for instance, the corporation uses its surplus and undivided profits in purchasing securities and thereafter distributes such securities among its stockholders as a dividend, it would

19 Letter from Treasury Department dated February 18, 1915; I T. S. 1917, ¶ 178. This rule is not changed by the amendment of October 3, 1917, which expressly provides that in the case of distribution in 1917 or subsequent years the amount distributed shall be considered as a part of the annual income of the distributee for the year in which it is received.

20 Letter from Treasury Department dated January 19, 1915; I. T. S. 1917, ¶ 168. Scrip dividends were held taxable under the Act of June 30, 1864. Bailey v. Railroad Company, 106 U. S. 109.

seem clear that the value of the securities, either at the time of purchase or at the time of the distribution, would measure the money value of the dividend. The time at which the corporation acquired the securities would seem to be the proper time at which to determine the money value of such a dividend, since any increase in the value above the cost of such securities, at the time of distribution, had not been realized as earning or profit of the corporation, and, it must be borne in mind, a dividend is taxable only to the extent that it represents earnings or profits of the corporation.

DIVIDENDS PAID IN LIBERTY BONDS. The fact that dividends are paid in Liberty Bonds does not make that income exempt from tax. The tax is upon the income itself as an entirety and not upon the specific articles into which this income is finally transmuted. When Liberty Bonds are used as a medium of payment, whether in discharge of a private debt or a corporate dividend, profit or gain to the recipient is nevertheless subject to income tax.[21]

TAXES PAID FOR SHAREHOLDERS TO BE CONSIDERED AS DIVIDENDS. Where a corporation, such as a bank, pays taxes assessed upon the respective interests of its shareholders, under laws which require the corporation to pay such taxes on behalf of its shareholders, the pro rata amount so paid on his shares should be reported

21 Letters from Treasury Department dated June 30, 1917, and June 22, 1917; I. T. S. 1917, ¶¶ 2257 and 2258. The second of these letters is based upon an opinion on the subject obtained from the Attorney General by the Treasury Department. The question was raised by reason of the language of the Act authorizing the first issue of Liberty Bonds, which exempted the principal and income from taxation.

by the stockholder as a dividend. The same amount may also be deducted as a tax of the stockholder paid for him by the corporation as his agent. The net result of reporting such amount as a dividend, and claiming the same amount as a deduction, is that the amount of tax is offset against the stockholder's income from other sources in assessing the normal tax.[22]

Stock Dividends. The 1916 Law expressly provides that stock dividends shall be taxable. It defines a stock dividend as a distribution by a corporation out of its earnings or profits accrued since March 1st, 1913, and payable to its shareholders in stock of the corporation. It also provides that such stock dividends shall be considered income, to the amount of the earnings or the profits so distributed.[23] A stock dividend is only taxable where a cash dividend would be taxable. Any distribution made in the form of a stock dividend, which would not be taxable if made in the form of a cash dividend, is not made taxable by reason of the distribution being made in stock.

Rule Under 1913 Law. The 1913 Law was silent as to stock dividends, and it was at first held by the Treasury Department that such dividends were not subject to tax, on the theory that the additional shares of stock issued to the stockholder represented no more than the same interest in the identical property represented by his stock before the dividend. The Treasury

[22] For a further discussion of this subject see Chapter 30 on Deduction of Taxes.

[23] Act of September 8, 1916, § 31, added by Act of October 3, 1917. The 1916 Law prior to the amendment contained substantially the same definition of stock dividends.

Department subsequently changed its attitude and held stock dividends to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends.[24] Only one case has been decided under the 1913 Law, and in that case the District Court held a stock dividend to be taxable.[25] The court said in part:

"I can give little weight to the argument that the issue of a stock dividend did not affect the market value of the plaintiff's aggregate holdings and that the distribution of 50% more stock to the stockholders lessened the market price of their original stock 33⅓%. This would be true in case of any cash dividend extraordinary, or even ordinary. The cash distributed, plus the market value of the stock after the dividend was paid, would ordinarily be equivalent in value to the stock before the dividend. But the objection seems impressive that the transaction in nowise affected what the stockholder already had except to give him additional pieces of paper evidencing his ownership. He does, however, have something different before and after receiving the additional stock. What was before a mere chance that he might receive his share of the surplus in cash dividends, and a vague right to secure them if the directors withheld them in a way and to an extent that indicated bad faith, is now converted into a permanent interest in the capitalized surplus. He has lost the chance of cash dividends and gained an interest in the corporate enterprise that cannot be taken away. This interest

24 T. D. 2274, dated December 22, 1915.

25 Towne v. Eisner, U. S. D. C. S. D. N. Y. 242 Fed. 702. In this case it was also held that the dividends were subject to tax although declared from surplus, all of which was earned prior to January 1, 1913, and paid January 2, 1914. The case is now before the Supreme Court on appeal.

is derived from earnings and may be really of much greater advantage to the stockholder than the possibility or right which he has lost. It becomes capital of the corporation, but in his hands it is income and in many respects resembles the common extraordinary cash dividend accompanied by a right to subscribe for additional stock at par to an amount equivalent to the dividend in cash. To say that this distribution is not income because he received no cash and the intermediate step is not taken is, to my mind, quite to disregard the real nature of the transaction. * * *

"The real stumbling block which affects everyone * * * is the taxation of very large accumulations of earnings distributed by corporations after the passage of the Act. Certainly the mere matter of size can make no difference in determining whether the property taxed is income or not. The doubt I have felt in reaching my conclusion has not been due to the nature of stock dividends, but to the difficulty * * * in determining whether Congress intended to tax earnings at all which had accrued in the hands of the corporation prior to the passage of the Act, but were distributed later." The 1916 Law "providing that a cash or stock dividend payable out of earnings since March 1, 1913, shall be considered income has no bearing upon this case. It may be argued that it was a limitation or an extension of the income taxable by the Act under consideration, but in neither event can it be held to define the income which was theretofore taxable."[26]

[26] As a practical matter it seems absolutely necessary that the law should tax stock dividends, otherwise the supertaxes could be avoided by individuals forming corporations to hold their personal estates and reinvesting the earnings from year to year, the yearly surplus in each case being converted into capital by a distribution of stock dividends.

MONEY VALUE OF STOCK DIVIDEND. The present law provides that a stock dividend shall be considered income "to the amount of the earnings or profits so distributed." Prior to the amendment, the 1916 Law provided that a stock dividend should be taxable "to the amount of its cash value." Both phrases are construed to have the same meaning. The value of each share of the stock dividend, for the purpose of the income tax, is determined by dividing the amount of earnings, profit, or surplus distributed, by the total number of shares constituting the stock dividend. In other words, the amount which the stockholder would have received had payment been made in cash, is the amount to be reported as income.[27] The par value of a stock dividend usually indicates the amount to be reported as income. The fact that the stock dividend may have a market value, at the time it is received by the stockholder, greater or less than its proportionate value as a part of the surplus of profits distributed, does not alter the rule. In a subsequent sale of the dividend stock, the value at which it was reported as income when received as a dividend is to be considered as its cost, and the profit or loss realized from the sale should be figured accordingly, as in the case of any other sale of property.[28]

[27] Letter from Treasury Department dated October 30, 1916; I. T. S. 1917, ¶ 164.

[28] Letter from Treasury Department dated March 24, 1916; I T. S. 1917, ¶ 166.

CHAPTER 24

INCOME FROM ROYALTIES

The Treasury Department expressly requires that royalties from mines, oil wells, patents, franchises, or other legalized privileges shall be separately reported by the individual, but not by corporations. No particular rules have been issued with respect to royalties and with respect to income from royalties, except to hold that where royalty is received in exchange for a right to manufacture and sell an article under a patent, the amount of the royalty received is income.[1] In the case of mines operated by a lessee on a royalty basis, the amount of royalty received by the lessor is income.[2]

Royalties from Mines. In has been contended that royalties received under mining leases and oil leases are in fact not income but payments of instalments on the purchase price of the natural deposit. The nature of such leases has been the subject of some difference of opinion in the courts. It has been held that the leases are such in name only, and are in fact conveyances of the ore body in place as a part of the realty, and that the so-called royalties merely represented payments for so much land and were in no just sense income, but mere

[1] Letter from Treasury Department dated January 24, 1916; I. T. S. 1917, ¶ 1187.

[2] T. D. 2152.

conversions of the capital. On the other hand, it has been held that such leases do not constitute a sale of any part of the land and further, that ores or other materials derived from the usual operation of open mines or quarries, constitute the rents and profits of the land. The United States Supreme Court in a case arising under the 1909 Law reviewed the conflicting authorities, and held that under the language of that law royalties received under mining leases were income.[3] Under the present law such royalties are treated as income, against which the owner of the property may claim an allowance for depletion of the natural resource.

Royalties from Patents and Copyrights. Taxpayers receiving royalties from patents, copyrights, or other similar forms of property, may deduct from each payment a proportionate part of the cost thereof as representing, a return of capital. This is more fully discussed in a subsequent chapter.[4]

[3] Von Baumbach v. Sargent Land Company, 242 U. S. 503.
[4] See p. 294.

CHAPTER 25

INCOME FROM MISCELLANEOUS SOURCES

After specifying a number of sources of income, the act provides that the net income of the taxpayer shall include gains or profits and income derived from any source whatever. In this chapter are set forth the rulings on income from sources not covered by the preceding chapters.

Alimony. Alimony is not income, as it does not arise from any business transaction, and is not founded on any contract, but on the natural and legal duty of the husband to support the wife.[1] It follows that the husband cannot deduct the amount he pays as alimony from his income for the purpose of the tax.

Accident Insurance. Money paid to a person insured by an accident insurance policy, on account of accident sustained, is income (to the extent that the amount exceeds the aggregate premiums paid) but amounts received from a railroad company, by way of reimbursement for expenses incident to an accident, are not considered income. The proceeds of accident insurance policies paid to an individual beneficiary, upon the

[1] Gould v. Gould, U. S. Supreme Court, Case No. 41, October Term, 1917, not yet officially reported. This decision reversed the ruling of the Treasury Department.

death of the person insured, are not income to the beneficiary.[2]

Assessments on Stock. Assessments paid by stockholders on stock are not income of the corporation, nor is a voluntary contribution on the part of the stockholders, to make good a deficit of the corporation.[3]

Damages. An amount received as the result of a suit or compromise for "pain and suffering" is held to be income.[4] The law imposes the tax on income from all sources, but it seems unjust to tax one who receives in a lump sum an amount as damages to compensate him for a period of years on account of disability resulting from injury. In other words, he receives several years' income at one time and the supertax takes more than a just portion thereof, while the law does not even permit him to deduct the expenses of surgical and medical attendance from the gross amount of damages he may receive.

Increment to Sinking Funds. Where a sinking fund is set aside for the purpose of meeting obligations at a future date, all increment to that fund as a result of investments is income to the creator of the fund. Where a sinking fund, controlled by trustees, has been invested in the bonds of the corporation which created the fund, and the corporation pays the trustees interest on such bonds, the amount of interest may be deducted, the same as payment to any other bondholders, and within the

[2] T. D. 2135.

[3] Letter from Treasury Department dated February 21, 1916; I. T. S. 1917, ¶ 1196.

[4] T. D. 2135.

limitation fixed by law, but the same amount must be included as income to the corporation from the sinking fund.[5]

Legacies. A legacy is a gift and the value thereof is not considered income to the recipient, but all income created by the legacy is taxable. Unless clearly inconsistent with the intention of the testator, a legacy is held to be vested rather than contigent, and where there is a vested interest the income therefrom, whether distributed or not by the executor or administrator, is subject to the tax from the time of death of the testator, as income of the legatee.[6]

Pensions. Pensions paid by the United States Government are subject to the income tax,[7] as also are pensions paid by any other government, or by any private interest, under any contract express or implied. If, however, a so-called "pension" is a mere gratuity or gift it is not taxable as income to the recipient.

Proceeds of Life Insurance Paid to Individual Beneficiaries. When the proceeds of a life insurance policy are paid to an *individual* beneficiary upon the death of the insured, the amount of the policy is exempt and need not be included as gross income of the individual,[8] and this is true whether the payments of such proceeds are made in a lump sum at the death of the insured, or in instalments thereafter, or as annuities.[9] If the instalments are not paid in accordance with the

5 T. D. 2161.
6 T. D. 2090.
7 T. D. 2090.
8 Act of September 8, 1916, § 4, Reg. 33, Art. 5.
9 Letter dated December 29, 1913; I. T. S. 1917, ¶ 301.

terms of the policy, but under agreement made between the insurance company and the beneficiary, any amounts of accretion to the sum payable under the terms of the policy will be taxable as income.

Proceeds of Life Insurance in Favor of Corporations. Where a corporation has insured the life of an officer or employee or other person in favor of the corporation it is not allowed to deduct as an annual expense the amount of premium paid, but such annual payments of premium will be considered as investment of capital and, when the policy is paid at maturity, the aggregate amount of the premiums paid during the term of the policy may be deducted from the proceeds of the policy, the remainder being income for the year in which it is received.[10]

Property Acquired by Gift. The value of property acquired by gift, bequest, devise or descent (but not the income from such property) is exempt. Such property need not be reported as income by the recipient.[11] It was held under the 1913 Law that gifts to corporations were not exempt, but this ruling does not apply under the 1916 Law, since the provision of the former law exempting income of this character was contained in the subdivision applying particularly to individuals, while in the latter it is placed in a section having general reference to all taxpayers. It would seem under the present law that income of this character is exempt from the tax regardless of the status of the recipient.[12]

10 T. D. 2519. Act of September 8, 1916, § 32, added by Act of October 3, 1917.

11 Reg. 33, Art. 5.

12 Compare Act of October 3, 1913, ¶ B and Act of September 8, 1916, § 4.

Definition. Christmas presents, gratuities, voluntary contributions and donations are considered as gifts and should not be reported as income by the recipient. An exception, however, is made in the case of clergymen; Easter offerings, and fees received by them for funerals, masses, marriages, baptisms, etc., while in the form of gifts, are in fact payment for services and should be reported as income.[13] Special payments made by an employer as extra compensation to employees are sometimes called bonuses or gifts, but if made as compensation for services rendered, and paid in pursuance of a contract, express or implied, they are in fact not gifts but income from services, and taxable to the recipient.[14] Where the salary of an employee is paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no services being rendered by the recipient, the payments are gifts and exempt from taxation.[15] Of course, any amount paid by one person out of his income to another, as a gift, is not deductible from the net income of the giver.[16]

Sale of Property Acquired by Gift. When property acquired by gift is thereafter sold, the value of the property at the time the gift was made is deducted from the amount received on the sale thereof and the remainder is taxable as income of the seller.

Recoveries on Bad Debts. Where a bad account has been charged off to profit and loss and subsequently

13 T. D. 2090.

14 T. D. 2152. See Chapter 17.

15 T. D. 2090, Reg. 33, Art. 6.

16 See Chapter 27 on Deductions.

the money is recovered, the sum so recovered must be treated as income whether or not the bad debt was charged off prior to the incidence of the tax or subsequent thereto. The fact that a bad debt has been charged off prior to the incidence of the tax does not make it any the less income for the year in which it is recovered.[17]

Rights to Subscribe to Stock. Where a stockholder acquires the right to subscribe to new stock of the corporation and sells that right, the amount received is considered as income.[18] If he exercises the right, no income accrues until the stock subscribed for is sold.

[17] Letter from Treasury Department dated February 11, 1916; I. T. S. 1917, ¶ 1163. The term "incidence of the tax" means the time when the tax first applied to the taxpayer. Generally it is used to indicate March 1, 1913.

[18] Letter from Treasury Department dated February 27, 1915; I. T. S. 1917, ¶ 287.

CHAPTER 26

RECEIPTS WHICH ARE IN PART RETURN OF CAPITAL

Income is not synonymous with receipts. The tax is on income, gains and profits. The true function of the words "gains" and "profits" is to limit the meaning of the word "income" and to show its use only in a sense of receipts which constitute "gains" and "profits." The increased value of capital as such constitutes, in one sense, a gain or profit, but does not constitute income until the property has been sold or disposed of for cash or its equivalent. When so sold, the entire income is not gain or profit, but only so much thereof, according to the rulings of the Treasury Department, as the selling price exceeds the cost of such property. In an early case it was said that "income is that which capital earns remaining itself intact."[1] Often receipts represent a change of capital investment or a distribution of capital assets. In that case there is no gain or profit. If such receipts were regarded as income the taxpayer's capital would be depleted.[2] The law does not attempt to tax such receipts, as is evidenced by the language of the section (under the somewhat misleading head of exempt income) which provides, among other things, that the

1 People v. Davenport, 30 Hun. 177. This definition was adopted in Mitchell v. Doyle, 225 Fed. 437, and is in substance what the court held in Southern Pacific Company v. Lowe, 238 Fed. 847, and in the cases cited in that opinion.

2 Lynch v. Hornby, 236 Fed. 661; Lynch v. Turrish, 236 Fed. 653.

amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract, or upon the surrender of the contract, is exempt.[3] The further provisions of the law holding that gain derived from the sale or other disposition of property acquired before March 1st, 1913, shall be taxed only to the extent that it is measured by the difference between the fair market price or value of such property as of March 1st, 1913, and the selling price, indicate that Congress did not intend to tax any income, gain or profit, or growth of capital, which took place prior to March 1st, 1913. Whatever growth took place in the capital of the taxpayer up to that date, and whatever amounts such capital had earned prior to that date, became capital on that date, so far as the income tax law is concerned. Another provision evidencing this intent is that which expressly provides that dividends from earnings or profits accrued to a corporation prior to March 1st, 1913, shall not be taxable on distribution to the shareholders. The Treasury Department, in the main, follows this principle, but deviates from it in some respects as, for instance, in the case of depreciation, where it requires the annual depreciation allowance to be based upon the original cost of the property whether acquired before or after March 1st, thus denying to the taxpayer a return of the full value of his capital on March 1st, 1913, in cases where the value of his property increased between the time it was originally purchased and that date. In most cases it is a comparatively simple matter to divide receipts into two parts, one representing return of capital (which is not taxable) and the other representing income

[3] Act of September 8, 1916, § 4.

(which is taxable) as the following rules will indicate. Difficulty sometimes arises in segregating capital and income in the case of instalment payments for goods sold in the course of business. The rulings which have been issued by the Treasury Department indicate, however, a method which might be adopted in handling such payments, as more fully appears in a later part of this chapter.

Dividends on Life Insurance Policies. Dividends paid on life insurance policies that have not matured, whether or not such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income. Dividends from paid-up policies, however, are considered income. The former represent merely a return of a part of the premium theretofore paid by the insured, while the latter represent a distribution of income earned by the insurance companies on the premiums paid by the insured, and, when paid to the insured, should be treated the same as dividends from corporations.[4]

Surrender Value of Insurance Policies. When an insured person discontinues insurance prior to the maturity of his policy, he is entitled to a certain surrender value which is paid to him by the insurance company. The amount so received represents the return to the insured of a part of the premiums he has paid in the past, and is therefore not income. If the amount should exceed the aggregate of premiums paid, the excess would be taxable income.[5]

[4] T. D. 2137.

[5] T. D. 2090, as amended by T. D. 2152. Letter from Treasury Department dated February 8, 1917; I. T. S. 1917, ¶ 2002.

Endowment Policies. Where an endowment policy is paid to the insured, it is exempt from tax to the extent that the payment represents a return to the insured of amounts paid by him from time to time as premiums, but is taxable on the excess.[6] Thus, if over a period of years the insured has paid $700 in premiums. and, at the expiration of the term receives $1,000 from the insurance company, $300 of that sum is taxable income, but the $700, representing return of premiums, is not income.

Annuities. So much of annuities paid to an annuitant as represents payment made by him on the annuity contract, is not taxable income. Any increment on the purchase price of the annuity is taxable income.[7] The Treasury Department has not prescribed any rules for determining what part of each payment of an annuity is income and what part represents return of principal. In the case where one has purchased a life annuity it seems the annuitant should be permitted to deduct annually a part of the purchase price determined perhaps by dividing the total purchase price of the annuity by the number of years of his expectation of life, as shown by the insurance mortality tables, at the time of purchase. Thus if the expectation of life is fifteen years, the purchase price should be divided by fifteen and only so much of the annuity as exceeds this sum each year can reasonably be said to be income to such annuitant.

Matured Shares in Building and Loan Association. Where the amount paid back to a depositor by a building

6 T. D. 2090, as amended by T. D. 2152.

7 Letter from Treasury Department dated January 12, 1914; I. T. S. 1917, ¶ 306.

or loan association, at the maturity of the series, exceeds the aggregate deposits made to that series, only the defference between the total amount received for the surrender of the matured certificate and the aggregate of the deposits made by the certificate holder, is to be returned as income.[8]

Compensation by Insurance. Insurance money is clearly a substitute for the assets lost or destroyed. The money so received from the insurance company is not income, but a direct compensation for the property lost, and it is expressly provided by the law that no loss can be claimed for property destroyed when such loss is compensated for by insurance.[9]

Timberlands. The value of timberlands at the incidence of the tax may be deducted pro-rata as the lumber is cut and sold in that such value represents the capital of the owner.[10] The Treasury Department has published several rulings describing the procedure to be followed in claiming annual allowances for the return of capital in the case of owners of timber properties, which are summarized in the following paragraphs.

Basis of Allowance. Owners of timberland logging off the timber and manufacturing it into lumber will be permitted to exclude from gross income, either through a deduction from gross receipts or through a charge into the cost of manufacturing the timber into lumber, an amount equivalent to the fair market price or value of

8 Letter from Treasury Department dated February 8, 1917; I. T. S. 1917, ¶ 2000.

9 Act of September 8, 1916, §§ 5 and 12.

10 Doyle v. Mitchell, 235 Fed. 686.

the standing timber as of March 1, 1913, if the property was acquired prior to that date or the actual cost, that is, the gross purchase price of the timber property, if purchased subsequent to that date.[11]

FAIR MARKET VALUE AS OF MARCH 1, 1913. The fair market value of timber or timberlands as of March 1, 1913, is the price at which the property, in its then condition and with the circumstances then surrounding it, could have been sold for cash or its equivalent. The value must not be speculative, but must be determined without taking into account any prospective profit that may result from the manufacture of the timber into lumber. It must be as the law contemplates, a fair market value, and, once determined, must be set up on the books. As the measure of a stumpage deduction for income tax purposes, it must remain constant and cannot be increased. The department does not specifiy any particular method of arriving at the fair market price or value as of March 1, 1913, but requires the owner to determine the amount which, in his opinion, is the fair market price or value as of that date, and to calculate his deduction on that basis. The amount so determined by the owner will be given due consideration, and, if at a later date it appears to the Treasury Department that it does not represent the fair market price or value, the owner will be advised and be given an opportunity to present reasons and facts as to why the figures should be accepted.

GROSS PURCHASE PRICE. If the property is purchased subsequent to March 1, 1913, the Treasury Department

11 Letter from Treasury Department dated March 3, 1917; I. T. S. 1917, ¶¶ 2164 and 2165.

will allow, as the basis of the annual deduction, an amount representing the original cost of such timber plus any carrying charges that may have been capitalized or not deducted from income, the purpose being to secure to the owner, when the timber has been exhausted, an aggregate amount which, plus the salvage value of the land, will equal the capital actually invested.[12]

PROCEDURE IN CLAIMING ANNUAL ALLOWANCE. After determining the value of the property as of March 1, 1913, or its cost, if purchased subsequent to that date, the number of feet (board measure) in the entire timber holdings should be estimated. By dividing the original cost or value by this number, the per unit value or price will be ascertained. This per unit value multiplied by the number of feet of timber removed each year will measure the annual deduction, which may be made until the aggregate amount equals the amount of capital invested. When the capital has been so extinguished, the entire amount thereafter realized from the logged off lands, or from other salvage, will be returned as income of the year in which the timber or the lands are sold or disposed of. If the timber or timberlands are sold *en bloc* the gain or loss will be ascertained on the basis of the difference between the fair market price or cost (less any amounts which have been deducted as return of capital) and the selling price, according as the property was acquired before or after March 1, 1913.[13]

Instalment Payments. Where real estate is sold on a monthly instalment basis under a contract which vests

12 Reg. 33, Arts. 139 and 140.

13 Letter from Treasury Department dated March 3, 1917; I. T. S. 1917, ¶¶ 2164 and 2165.

possession of the property in the vendee, but explicitly retains title in the vendor and provides for reversion to him in case of default on the terms of the contract, it has been held that every dollar received under the contract represents in part a return of a portion of the cost of the property to the vendor and in part a portion of the total profit to be derived from its sale, and that the amount of profit represented should be taken into consideration in computing gain or profit during the year for income tax purposes. Thus, where the cost of the property is $250 and is sold for $450, four-ninths of the selling price represents the profit and that fraction of each instalment payment should be returned as gross income, against which the vendor may claim allowable deductions. If under the terms of the contract a default in payment occurs, and the vendor retains all payments received, as liquidated damages, the vendee losing all right and title to the property and to the amount of payments made, the entire amount theretofore received and treated as a return of capital, should be included as income for the year during which the default occurs.[14] This seems to be a logical method to follow in every case of payments by instalment for goods or property sold in the ordinary course of business, as it distributes the income over the entire period during which payment is being made. On the other hand, the selling-price may be treated as a receipt in the year in which the goods are sold, subsequent instalment payments being treated as partial payments of debts and unpaid instalments being treated as worthless debts in the year they are ascertained to be a loss. The segregation of capital and income in each instalment payment has the advantage,

[14] Letter from Treasury Department dated March 14, 1917; I. T. S. 1917, ¶ 2215.

however, of taxing the income or profit from the sale in the year in which it is actually received.

Royalties from Patents. An allowance for return of capital, in the case of one receiving royalties from patents, is permitted on the following basis. The deduction for exhaustion of capital assets represented by the patents should be each year one-seventeenth of the actual cost of such patents. Where the patent has been secured from the Government, by the taxpayer claiming the deduction, its cost would represent the various government fees, cost of drawings, experimental models, attorneys' fees, and other expenses. Where the patent has been purchased for a cash consideration, the purchase price represents the cost. Where a corporation has purchased a patent and made payment therefor in its own stock or other securities, the actual cash value of such stock or other securities at the time of purchase will represent the cost.[15] Where depreciation at this rate has been claimed for one or more years and the value of the patent disappears, through obsolescence or any other cause, in a subsequent year, the unreturned cash investment remaining in the patent may be claimed as a total loss and be deducted from the income of that year.[16] Where a patent is purchased after it is partially expired the cost of the patent may be divided by the number of years of life of the patent remaining at the date of purchase. Thus, for instance, if a patent has ten years to run at the time of purchase, one-tenth of the cost may be deducted each year.[17]

15 Reg. 33, Art. 137.

16 Reg. 33. Art. 138.

17 Letter from Treasury Department dated September 24, 1915: I. T. S. 1917, ¶ 1414.

Royalties from Copyrights. Allowance for return of capital invested in copyrights may be taken by the owner of the copyright in the same manner as stated above in the case of patents, taking the life of the copyright as the divisor, the cost as the dividend, and the result as the amount of the annual allowance.

Royalties from Lease of Natural Deposits. In the case of mines, oil wells, and gas wells, the law provides expressly for methods of determining the annual allowance for depletion. See the Chapters on Depletion.[18]

18 See Chapters 33 and 34.

CHAPTER 27

DEDUCTIONS—IN GENERAL

In determining the net taxable income of an individual or a corporation certain deductions are specified in the law. While the deductions allowed both corporations and individuals are based upon the same principles they vary in some particulars, due to differences in the status of the two classes of taxpayers. Thus, the corporation may deduct the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, while an individual may only deduct the necessary expenses actually paid in carrying on any business or trade, not including personal living or family expenses. On the other hand, an individual may deduct all interest paid within the year (subject to one exception applicable to both individuals and corporations) while a corporation is limited to a deduction of interest paid on indebtedness not exceeding one half of its total indebtedness plus the amount of its capital stock outstanding. Again, all losses sustained by a corporation during the year may be deducted but in the case of individuals, losses incurred in transactions entered into for profit not connected with the taxpayer's business or trade may be deducted only to an amount not exceeding the profits arising from such transactions. In the case of corporations and individuals the allowance for depreciation is limited

to property used in the business or trade of the taxpayer, but in the case of corporations the amount must be actually "charged off." Taxes paid during the year may be deducted to the same extent by both individuals and corporations. In the case of non-resident aliens and foreign corporations the deductions are intended to be limited to such expenses, losses, etc., as are incurred in the creation of the income which is taxed by this Government. The special provisions applicable to individuals, corporations, non-resident aliens and foreign corporations are set forth in the chapters dealing respectively with those subjects. The general provisions applicable to all taxpayers are discussed in this and the following chapters.

Only the Deductions Specified in the Statute Are Allowed. It must be borne in mind that although the tax is imposed on the net income of a taxpayer, yet the net income so taxed is that which is specifically defined in the statute, and not that which may be generally termed net income in accounting practice or recognized as such by custom. There may be, for instance, many deductions dictated by prudence and good business management which are not recognized or countenanced by the law. Only those deductions which are expressly specified in the statute may be taken for income tax purposes.

Deductions Must Be Actual. The deductions specified in the statute can be deducted by the taxpayer only in case they represent actual payments or actual liabilities. It is not permissible, for instance, for a taxpayer owning the property used and occupied for his or its own business purposes to include as a deduction

the rental value of the property so owned. Neither is it permissible to deduct an amount representing the interest which might be earned on the capital employed in the business, if such capital were invested or employed otherwise, or so placed as to earn a given rate of interest.[1] Primarily the deductions claimed in any year must be those represented by actual cash disbursements on the part of the taxpayer unless the taxpayer has chosen to report on some other basis than that of actual receipts and disbursements.

Reporting Deductions According to Book Entries. Where an individual or a corporation, keeping accounts upon any basis other than that of cash receipts and disbursements, has elected to report his or its net income according to such basis, and is permitted by the Treasury Department to do so, both the income and the authorized deductions must be computed and accounted for on the same basis, and the same practice must be consistently followed year after year. When deduction is made of the amounts accrued or reserved, a further deduction cannot be made when the actual liability or obligation is paid. In so far as the accrual or reserve is sufficient to meet the liability it must be charged against the fund created to meet it. If it is found upon investigation that returns made upon the basis of accruals and reserves do not reflect the true net income, the taxpayer will not thereafter be permitted to make returns upon any basis other than that of actual receipts and disbursements.[2] The Treasury De-

[1] T. D. 2137.

[2] T. D. 2433. Although this Treasury Decision refers expressly to corporations, and not to individuals, and no similar rules have been prescribed with respect to the latter, there seems to be no

partment has always held, in the case of corporations, that it was immaterial whether deductions, except for taxes and losses, were evidenced by actual disbursements in cash, or evidenced in such other ways as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets. Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned by a corporation for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.[3] No special system of bookkeeping has been required, nor any specific method prescribed in rulings or regulations by which the net income should be determined.[4] As to taxes, the Department held in the past that the tax must be actually paid, and not merely entered as a charge, in order to be deducted, and in the case of losses the loss must be actually sustained and not merely charged off. As to taxes, the rule seems to be changed in the case of corporations electing to report according to their books, as indicated in the following paragraph.

ACCRUALS. Corporations which accrue on their books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, may deduct from their gross income the amount so accrued, provided such accruals approximate as nearly as possible

reason why an individual should not be permitted to avail himself of the same privilege of reporting on a basis other than that of actual receipts and disbursements, since the law extends the privilege to both in identical language.

3 Reg. 33, Art. 158.

4 T. D. 2161.

the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis, income from fixed and determinable sources accruing to the corporation is returned, for the purpose of the tax, on the same basis.[5]

RESERVES TO MEET LIABILITIES. Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of the Interstate Commerce Commission or of any federal, state or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which, and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, the amount credited to such reserves may be deducted, provided the amounts deductible on account of the reserves approximate as nearly as can be determined the actual amounts which experience has demonstrated will be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves are made. If it is found that the amount credited to any such reserve is in excess of the reasonable or probable needs for which the reserve was created, the excess will be disallowed as a deduction and restored to income for the purpose of the tax. In no event will sinking funds or other reserves set up to meet additions, betterments or other capital obligations be allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., are not allowed as deductions, since such losses are only deductible when definitely determined

5 T. D. 2433.

as a result of a closed or completed transaction and actually charged off.[6]

Additions and Betterments. The law provides expressly in the case of individuals and corporations that no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate, and no deduction shall be made for any amounts of expense in restoring property or making good the exhaustion thereof for which an allowance is or has been made.[7] Amounts expended for additions and betterments are considered as a capital investment.[8] Thus, expenditures of a railroad for sidings or spur tracks are additions and betterments and therefore not deductible.[9] If expenditures are made for permanent improvements and betterments they are treated as any other investment of capital, that is, if the asset in which the capital is invested is one on which depreciation may be claimed, the amount expended for the permanent addition or betterment is added to the cost of the property for the purpose of determining the annual depreciation allowance thereafter. The statute merely intends to prohibit the deduction of the entire amount in the year in which the expenditure is made.

Public Utilities. In a decision under the 1909 Law it was held that the fact that, under the laws of California, a public utilities corporation is not the owner

6 T. D. 2433.

7 Act of September 8, 1916, §§ 5, 6 and 12.

8 Reg. 33, Art. 118.

9 Grand Rapids and Indiana Railway Company v. Doyle, T. D. 2210.

of the property, but merely intrusted with the use thereof, did not entitle it to more favorable treatment than other corporations. Money received from the consumers to pay for service connections to be laid in public streets was held to be income on which the corporation was liable to pay a tax, notwithstanding that all or nearly all of the sums so received may have been expended in betterments and extension of its system. Moneys expended for service connections and pipe extensions are invested in permanent improvements, and do not come within any of the permitted classes of deductions mentioned in the statute.[10] They are not in the nature of improvements made merely to facilitate the transaction of a growing business, the expenses of which have been held deductible.[11]

Expense of Restoring Property. Expense of restoring property or making good the exhaustion thereof is not an allowable deduction where a depreciation allowance is or has been made for the purpose, that is, where an annual allowance has been claimed for depreciation of property subject to wear and tear, the expense of restoring such property may not again be deducted, but must be taken out of the sum so set aside for depreciation.

Voluntary Destruction of Property. Losses due to voluntary removal of buildings, etc., incident to improvements, are not allowed as a deduction. It is presumed

10 Union Hollywood Water Co. v. Carter, 238 Fed. 329. It would seem, however, that it is unjust in a case like this to tax the company on its receipts where the money is for improvements and betterments to property which it does not own.

11 See Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, referred to in Chapter 28.

that depreciation up to the time of the removal has been covered by previous depreciation charges and the residuary value of the building removed is considered a part of the cost of the new building, that is, as a capital investment to be added to other items of cost on the aggregate of which depreciation of the new building may be based.[12]

Special Assessments for Local Benefits. The law expressly provides that assessments against local benefits shall not be deducted as taxes, although frequently referred to as taxes and imposed by local governments. Such assessments as, for instance, for 'paving, curbing, installing sewage and water systems, etc., are held to be expenditures which add to the value of the property and should be capitalized, that is, added to the cost of the property for the purpose of determining the loss or gain in a subsequent sale of such property.[13]

12 Reg. 33, Art. 127.

13 Letter from Treasury Department dated December 22, 1914; I. T. S. 1917, ¶ 1342. See Chapter 20.

CHAPTER 28

DEDUCTION OF BUSINESS EXPENSES

The law permits to individuals the deduction of the necessary expenses actually paid in carrying on any business or trade (limited in the case of non-resident aliens to business conducted within the United States) and in the case of corporations all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken, or is not taking, title, or in which it has no equity (limited in the case of foreign corporations to business and property within the United States). The special provisions applicable to each of these four classes of taxpayers are discussed in the chapters on citizens and residents, non-resident aliens, corporations and foreign corporations, respectively. The discussion in this chapter is limited to the rules applying generally to all taxpayers. As a general rule, the expenses which may be deducted are those necessary for the creation of the income which is taxed. It should be noted, however, that the language of the law contains some express limitations, which are more fully discussed in the following paragraphs.

Deductions Not to Be Duplicated. Where a deduction may, or should be, claimed as one of the items spe-

cifically stated in the law, such deduction should not also be included under the head of business expense. Thus, where a deduction is claimed for depreciation, or loss, the same amount should not also be deducted as expense, or if the cost of tools or small articles has been charged to expense, depreciation should not be claimed thereon, as it would result in allowing the same deduction twice. Interest paid by a corporation constitutes a separate deduction and should not be taken into account as a part of the cost of manufacture.[1]

Expenses Incurred in Earning Exempt Income. Expenses incurred in earning income which is not subject to tax do not constitute allowable deductions in computing net income from other sources which are taxable.[2]

Expenses of Operation. Expenses of operation include all expenditures for material, labor, fuel, and other items entering into the cost of the goods sold or inventoried at the end of the year, and all other expenses incurred in the operation of the business, except such as are required by the act to be segregated in the return,[3] or have been considered in determining the cost of purchases during the year. Payments for labor and materials which go into the actual operating of a railroad and its properties are deductible.[4]

Cost of Manufacturing Products. One engaged in manufacturing may include as an element of the cost of manufactured products, the cost of raw material, the

1 T. D. 2137.
2 T. D. 2137.
3 Reg. 33, Art. 114.
4 Grand Rapids & Indiana Ry. Co. v. Doyle, T. D. 2210.

cost of labor of the men who actually work on such products as well as the cost of supervisory labor such as that of foremen, inspectors, overseers, etc., provided such expenditures are not separately deducted from gross income in the return of annual net income.[5] This ruling permits certain items of wages and salaries to be included in the cost of the manufactured product, or to be separately listed as labor, wages, commissions, etc. The items however, should not be listed under both heads, as this would constitute double deduction of the amounts.

Sums Expended for Materials Used and on Hand. Where a business carries materials and supplies on hand for use, the cost thereof, to be included as an expense for the year, should be only the amount paid for the materials which are actually disbursed and used in operation during the year.[6] Amounts expended for materials to be used in subsequent years are proper deductions in the year in which the materials are used.

Commissions. Commissions paid to a real estate agent for collecting rents and managing property are allowed as a business expense to the owner. Commissions paid to salesmen as a part of the expense of conducting business are also allowed as deductions.[7]

Commissions Paid in Stock. Commissions allowed to salesmen, paid in stock, are deductible as an expense, if so charged on the books, at the actual value of such stock.[8]

5 T. D. 2152.
6 Reg. 33, Art. 123.
7 T. D. 2090.
8 Reg. 33, Art. 117.

Entertainment Money. So-called spending or treating money actually advanced by business enterprises to their traveling salesmen, as a part of the selling expense of their product, is a proper deduction. There must, however, be some showing that all of the allowance claimed as a deduction was actually expended for the purpose for which the allowance was made, namely, the selling of the product in question.[9]

Contributions for Campaign Expenses. Such contributions, and sums of money expended for lobbying purposes, are held not to be ordinary and necessary expenses of corporations and are therefore not deductible.[10]

Customs Duties. Customs duties may be either deducted as taxes or may be included as a part of the cost price of the goods, if the taxpayer is engaged in the importation of goods and merchandise.[11] Such duties of course should not be both included as cost of the goods and deducted as taxes.

Discounts. Discounts, other than bank discounts on notes executed by a corporation, were required, under the 1909 Law, to be segregated from the interest item on the return and to be included under expenses.[12]

Accounts Payable. Accounts payable actually charged into the expense account and so entered on the books as to constitute a liability against the assets of

9 T. D. 2090.

10 T. D. 2137.

11 Letter from Treasury Department dated December 22, 1914; I. T. S. 1917, ¶ 358.

12 T. D. 1675.

the company, and so treated in the preparation of the return of annual net income that they will not be included in the deductions of the year in which they are actually paid, may be deducted from the gross income of the year in which the expenses were incurred. This ruling applies only to accounts payable representing ordinary and necessary expenses of maintaining and operating the business, that is, such expenses as are incurred in producing the gross income which it is required to return.[13]

Expenses of Maintenance. Maintenance means the upkeep or preserving of the condition of the property to be operated and does not mean additions to the equipment, additions to the property or improvements of former condition of the property.[14] Expenses of maintenance are deductible.

Improvements. In the case of a railroad where old rails are replaced with new and heavier rails, wooden bridges and culverts with concrete and steel bridges and culverts, the rule is that the cost of renewals with like kind and quality is allowable, but excess cost is not allowable as a deduction.[15]

Repairs. Incidental repairs made to the business property of a taxpayer which neither add to the value of the property nor appreciably prolong its life, but keep it in an operating condition, are expense.[16] Incidental

13 Letter from Treasury Department dated March 2, 1915; I. T. S. 1917, ¶ 1267.

14 Grand Rapids & Indiana Ry. Co. v. Doyle, T. D. 2210.

15 Grand Rapids & Indiana Ry. Co. v. Doyle, T. D. 2210.

16 Reg. 33, Art. 131.

repairs are only those repairs which will not if continued, as the component parts wear out and are restored, make permanent the property. Expenditures for replacing worn out parts such as gears, bolts, nuts, valves, etc., so long as such replacements are not pursued to the extent of, and for the purpose of, finally restoring the machinery or equipment as a whole, constitute incidental repairs and are deductible as operating expenses. In addition, depreciation on the property so repaired may be claimed in order to replace the machinery, equipment or building when, as an entirety, it is worn out or is worthless for the purpose for which it is intended.[17]

Office Furniture and Equipment. An ordinary amount expended for renewal of office furniture and equipment, and charged to expense, was held not to be invested in assets, but to be a proper expense of maintenance of the business of an insurance company, which it was entitled to deduct in ascertaining its taxable net income under the 1909 Law. The company had expended in one year $1,213 for ordinary renewals of office furniture, in another year $1,379, and an additional sum of $1,808 for ordinary renewals of attendants' uniforms, door mats, window shades, awning, small hardware, oils and other articles of like character and also the sum of $2,244 for ordinary renewals of office equipment, consisting of lamps, alterations of fixtures, shades, meters, fans, plugs, wirings, etc., and these expenditures were no greater than the average of similar expenditures for other years and did not exceed 5% of the cost of all the plaintiff's existing furniture and equipment similar to the articles

17 Letter from Treasury Department dated September 19, 1916; I. T. S. 1917, ¶¶ 1363 and 1364.

detailed, and none of the items was considered in the corporation's books or statement as assets because of their rapid depreciation. It was held that the articles mentioned were of a perishable and transient nature, and properly charged to expense of maintenance, since they apparently did no more than maintain in proper condition and repair the ordinary equipment of office furniture and supplies.[18]

Expenditures for Alterations. In the case of a company which expended approximately $5,000 for alterations in its home office, apparently solely with a view of facilitating the carrying on of its business, it was held under the 1909 Law that such amount was properly deducted as an expense. The Court said in part: "It should be remembered, also, that in these days of up-to-date business method requirements it often becomes necessary for business concerns to change the lay-out and appointments of the places wherein they carry on business, with a view to economy in space, a saving of unnecessary labor, and the bettering of working conditions of employees, to the end that a net saving of running expenses will result. In view of the consistent expansion of the plaintiff's business, which the evidence shows, it would seem that the amount expended for the changes made in the office ought not, under the circumstances, to be considered unreasonable or unusual, and that, therefore, the amount claimed might well have been allowed as an item of deduction. It seems to the court that business concerns, in matters of this kind, should be allowed a reasonable discretion, and the law so enforced as to help rather than to hinder them in making reasonable progress in the development of

18 Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199.

their business, for it must appear to anyone giving the matter a moment's consideration that the more successful a business the larger the results, even from the standpoint of taxes accruing to the government.'' [19]

Payment in Lieu of Rental. Where a leasehold is purchased and paid for in one sum at the beginning of the lease the amount so paid may be divided by the number of years constituting the life of the lease and a deduction made annually of a proportionate amount, such item to be claimed as a payment made in lieu of rental.[20]

Repairs and Improvements Made by a Tenant. Where a lease requires the tenant to make all necessary repairs or improvements, which repairs or improvements revert to the landlord at the expiration of the lease, the tenant may charge the cost of all such repairs and improvements to the expense of doing business. If the improvements are somewhat permanent in character, the expense should not be all deducted in one year, but should be pro-rated over the number of years constituting the term of the lease, and the amount deductible from gross income of each year would be the aliquot part of such cost. [21] Taxes or other expenses paid by the tenant for the landlord should be deducted by the tenant as expense.

Cost of Buildings Erected by Tenant Under Terms of Lease. Where, under the terms of a rental or lease

19 Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206.

20 Letter from Treasury Department dated February 27, 1917; I. T. S. 1917, ¶ 2068.

21 T. D. 2137.

contract, a tenant agrees to erect a building, or to expend during the rental period a certain fixed sum in making improvements upon the freehold, it is held that the building or permanent improvements become a part of the realty, unless otherwise agreed upon between the contracting parties. As the use of the building or permanent improvement by the tenant, during the term of the lease, is a part of the consideration of the contract, the cost of such buildings or improvements may be pro-rated by the tenant over the leased term and be deducted, at an annual rate, as a part of the necessary expenses actually paid in carrying on any business or trade. The tenant may also deduct the cost of incidental repairs and maintenance to such buildings and improvements,[22] If the building is erected, or permanent improvements are made after the lease is partially expired, the cost thereof may be divided by the number of years the lease then has to run, and if the life of the lease is longer than the estimated life of the building or improvements, the cost may be divided by the number of years such building or improvements are expected to last, instead of the number of years constituting the life of the lease. [23]

Insurance Premiums. Where premiums are paid for insurance on property used for business purposes, or rented or leased to secure an income, the amount so paid constitutes an allowable deduction.[24]

Life Insurance Premiums. Premiums paid on life insurance policies covering the lives of officers, em-

[22] T. D. 2442, Reg. 33, Art. 115.

[23] Letter from Treasury Department dated February 27, 1917; I. T. S. 1917, ¶ 2064.

[24] T. D. 2090.

ployees, or those financially interested in any trade or business conducted by an individual, partnership, or corporation may not be deducted as a part of the annual expenses.[25]

Premium on Fidelity Bond. Where an employee is required to furnish a bond and pay the premium thereon, as a necessary incident to his employment, the amount so paid may be deducted by him as an expense.[26] If the employer pays the premium it may be included in his business expense.

Reserves for Insurance. Funds set aside by a corporation for insuring its own property are not a proper deduction as a business expense, but any loss actually sustained may be deducted although actually paid out of a fund so set aside.[27]

Salaries. As a general rule, it may be stated that any salary paid in good faith under contract, express or implied, for services actually rendered is an allowable deduction as a business expense of the employer. Inordinate salaries paid by an individual employer to relatives or others would no doubt be disallowed on the ground that they were not paid in good faith, and

25 Act of September 8, 1916, § 32, added by Act of October 3, 1917. Prior to the passage of this provision it was held by the Treasury Department that such premiums were deductible (T. D. 2090) but later this ruling was reversed and it was held thereafter that premiums were not deductible (T. D. 2519, dated August 30, 1917). It seems, from the language of this latter Treasury Decision, that it is not intended to have a retroactive effect for years prior to 1917.

26 T. D. 2090.

27 Reg. 33, Art. 122.

were in effect a method of distributing income so as to avoid the supertaxes. In the case of corporations, any salary paid to an employee who is not a stockholder would be a proper deduction unless the payment could be attacked for lack of good faith. Where the employee is also a stockholder, the salary deduction will be scrutinized with greater care, and in such cases it is important that the following rules be observed: (a) the services must be actually performed; (b) the amount must be no more than a fair and reasonable compensation for services rendered, and (c) the compensation should not depend upon the employee's interest in the corporation as a stockholder, or vary from year to year with the earnings of the corporation.[28] Under the 1909 Law it was held that in addition to the foregoing rules it was necessary that the salary paid to an officer who was also a stockholder should be authorized by the board and made a matter of record on the minute book of the corporation, in order to be an allowable deduction,[29] but this has not been required by any ruling under the present laws. It seems reasonable that an officer or employee of a corporation should be entitled to compensation for the services he actually performs, in addition to his dividends as a stockholder, since as a stockholder he is under no duty to devote any part of his time to the business of the corporation. What constitutes a reasonable salary is a question of fact, and it would seem that a fair criterion is the amount which similar services would command if the officer or employee were not a stockholder, or which he could get by rendering the same services to another

28 T. D. 2152; letter from Treasury Department dated February 2, 1915; I. T. S. 1917, ¶ 1284.

29 T. D. 1742.

employer. When the sum paid him exceeds such amount, the question will arise as to the propriety of deducting the salary as a business expense. It is conceivable, of course, that an individual may render services of great value to a corporation of which he is the chief stockholder, and if such services can be shown to be reasonably worth the salary paid, the courts will probably sustain the deduction as a proper expense, but the burden would be upon the corporation to prove that the payment was not compensation based on stockholding.

COMPENSATION BASED ON STOCKHOLDING. Where amounts paid as compensation or additional compensation to officers or employees are based upon the stock holdings of such officers or employees, such amounts are not allowed to be deducted as a business expense, but are held to be dividends even though paid in lieu of salaries or wages.[30] Where a company was composed of two stockholders who divided the net profits between them, calling it compensation, it was held that the money paid out was equivalent to a dividend and must be treated as such.[31]

SALARIES PAID TO ENLISTED MEN. A corporation continuing to pay an employee his salary, or part thereof, during his services in the United States Army is permitted to deduct the amount as an expense.[32]

Bonus and Profit Sharing Payments. Special payments made by a corporation as extra compensation to

30 Reg. 33, Art. 119.

31 Jacobs and Davies (Inc.) v. Anderson, 228 Fed. 505, T. D. 2262.

32 Letter from Treasury Department, dated October 4, 1916; I. T. S. 1917, ¶ 1286.

certain of its employees may be deducted as an expense, if it is clearly shown that such payments are made as compensation for services rendered and are paid in pursuance of a contract, express or implied.[33] If, however, there is no contractual relation between the employee and the employer by reason of which the employee could enforce his claim for the additional compensation, such payments will be held to be gratuities and not allowable as expense.[34] Such payments as extra compensation, when added to the salary received by the employee, must not exceed a reasonable compensation for the services rendered. A long time practice regularly employed of paying the employees certain sums in addition to the stipulated salaries constitutes a condition, if not a contract, under which the employees may reasonably expect, for the greater or better service which they render, additional pay, and if, in fact, such payments are made as additional compensation for services actually rendered and are reasonable in amount they may be treated as expense. The payments must be conditioned upon the services rendered by the employees, and not upon the earnings of the corporation. If dependent upon the earnings of the corporation, rather than upon the services rendered, or if such payments are made only occasionally, and then at the option of the corporation as a sort of a thank-offering because of a prosperous year, the payments will be held to be gratuities.[35]

GIFTS OR GRATUITIES TO EMPLOYEES. Gifts or gratuities made by an employer to his employees are not

33 T. D. 2152.

34 Letter from Treasury Department dated June 25, 1914; I. T. S. 1917, ¶ 1293.

35 Mimeograph letter to collectors No. 1314.

proper deductions as an expense. Even where such a payment is called extra compensation, if it is a gratuity or voluntary payment for which no service is rendered, its character as a gift is not changed. The custom of paying bonuses or Christmas gifts to employees, even though it has been the practice of the employer for a long time to make such gifts, does not make the amount so paid proper deductions as expense so long as the gifts are voluntary and gratuitous.[36]

Pensions. Amounts paid as pensions to retired employees, or their families, or others dependent upon them, or paid on account of injuries received by employees, are ordinary and necessary expenses,[37] but where the salary of an employee is paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no service being rendered by the recipient, the payment is held to be a gratuity, and not allowed as an expense of the business.[38]

Donations. Donations by business concerns may or may not be held to be proper deductions as expense. There must be a consideration in some form to take the donation out of the class of gratuities. It has been held that a corporation engaged in the agricultural business cannot be allowed to make deductions on account of donations to fairs, churches and associations; such donations, although made for the purpose of obtaining and preserving the good will of the farmers, being mere

36 T. D. 2090; T. D. 2152; mimeograph letter to collectors No. 1314.

37 T. D. 2090.

38 T.D. 2090.

gratuities. When a donation legitimately represents a consideration for a benefit flowing, directly or indirectly, to the donor, as an incident of its business, it is an allowable deduction. Thus, a donation to a hospital, under agreement that employees of the donor are to have a ward for their use in case of accident or illness, is a proper deduction. Donations made for purposes connected with the operation of the business, when limited to charitable institutions, hospitals or educational institutions, conducted for the benefit of employees or their dependents, are within this class.[39]

Lessees of Mines. Where an individual or a corporation operates a mine under a lease on a royalty basis, the lessee may deduct all royalties paid to the owner. If, in addition to royalties, the lessee has paid a stipulated sum for the right to explore, develop and operate a mine the amount so paid may be ratably distributed over the life of the lease, or the probable life of a mine under ordinary operating conditions, and the lessee may deduct annually as a rental payment an aliquot part of the amount of the bonus so paid, until such amount has been extinguished. If the annual deduction of the bonus is based on the probable life of the mine, under ordinary operating conditions, it seems that the lessee may compute the annual deductions of the bonus payment on the same basis as the owner computes depletion.[40]

Farmers. A farmer is permitted to deduct all legitimate expenses incident to the production of the year, or future years, although the products to which such expenses and deductions are incidental may not have

39 T.D. 2090.

40 T. D. 2446. See Chapters 33 and 34 on depletion.

been sold.[41] For example, the cost of a supply of fertilizer sufficient to last for several years may be deducted in full in the year in which purchased. A farmer may deduct as business expense the cost of ordinary tools, but not the cost of farm machinery of a more permanent character. Such farm machinery, however, is subject to depreciation as is other property subject to wear and tear.

Public Utility Under Contract with a State. In the case of a public utility constructed, operated or maintained under any contract with any city, state or territory or the District of Columbia, where a portion of the net earnings of such public utility is payable, under the contract, to the state, territory, etc., the amount so paid may be deducted by the public utility operating under such contract as an expense of its business.[42] This deduction is allowed under an express provision of the statute.[43]

41 T. D. 2153. A different rule seems to be applied in the case of manufacturers where it has been held that the cost of materials and supplies should be included only to the extent that the materials and supplies are actually used in the operations for the year. Reg. 33, Art. 123.

42 T. D. 2090.

43 Act of September 8, 1916, § 11 (b).

CHAPTER 29

DEDUCTION OF INTEREST

The law provides in the case of citizens and residents that all interest paid within the year may be deducted. In the case of a non-resident alien there may be deducted such proportion of all interest paid within the year by such person on his indebtedness as the gross amount of his income for the year derived from sources within the United States, bears to the gross amount of his income for the year derived from all sources within and without the United States, but this deduction is allowed only if such person includes in his return of annual net income all the information necessary for its calculation. In the case of a corporation there may be deducted the amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in business at the close of the year, plus (b) one half of its interest-bearing indebtedness then outstanding. It is further provided, as to corporations, that in case of indebtedness wholly secured by property collateral tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, as a dealer only, in the property constituting such collateral, or in loaning funds thereby procured, the total interest paid by such corporation within the year on any such indebtedness may be de-

ducted as a part of its expense of doing business, but interest on such indebtedness shall only be deducted to an amount of such indebtedness not in excess of the actual value of such property collateral. In the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, may be deducted in full. Foreign corporations are allowed to deduct the amount of interest paid within the year under the same limitation as imposed on domestic corporations and in such proportion as the gross amount of income for the year from business transacted and capital invested within the United States bears to the gross amount of income derived from all sources within and without the United States. The privilege of deducting the total amount of interest paid on indebtedness secured by property collateral is not allowed to foreign corporations, but the privilege of deducting all of the interest paid by a bank, banking association, loan or trust company, is extended to foreign corporations or the branches thereof to the extent that the interest is paid on deposits by or on moneys received for investment from either citizens or residents of the United States. The special rules applicable to each of the four classes of taxpayers enumerated above are discussed in the chapters relating to each.[1] In all cases indebtedness incurred for the purchase of obligations or securities, the interest upon which is exempt, may not be deducted.

1 As to citizens and residents see Chapter 4; as to non-resident aliens see Chapter 5; as to domestic corporations see Chapter 12; as to foreign corporations see Chapter 14.

Indebtedness Incurred for the Purchase of Tax Exempt Securities. Prior to the amendment of October 3, 1917, it was held under the 1916 Law that interest paid on indebtedness could be deducted regardless of whether or not the indebtedness was incurred for the purchase of bonds, the interest upon which was exempt from taxation. This ruling in effect permitted a double deduction, that is, the interest paid on the money so borrowed could be deducted and the income derived from the money so borrowed and invested could also be deducted. The 1917 Law does not permit the deduction of interest paid on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under that law. The phrase "obligations or securities" means only such securities as bear interest which is exempt from the income tax. State and municipal bonds are securities which would fall into this class. National bonds issued prior to September 1, 1917, would also fall into this class. But the limitation applies only where the interest on the securities so purchased is wholly exempt. Interest on indebtedness incurred for the purchase of Liberty Bonds of the second issue (the interest on which is not exempt from the supertax) may be deducted regardless of this limitation.[1a]

Interest Paid Within the Year. The 1909 Law provided for the deduction of "interest actually paid within the year" and it was contended by the Treasury Department that this provision required that the interest should be both accrued and paid within the same year. It was held by the Circuit Court of Appeals, however, that interest actually paid within the year although pre-

1a T. D. 2541.

viously accruing should be permitted as a deduction.[2] The 1913 Law provided for the deduction of interest paid within the year by individuals, and "interest accrued and paid within the year" by corporations. In a ruling appearing under that law it was held that in the case of corporations the deduction should be limited to interest which had both accrued and been paid within the same year.[3] The present law permits the deduction of interest paid within the year in all cases and it does not seem essential that the interest should have accrued or become payable in the year in which it is paid.

Interest paid by Corporations. The limitations on the amount of interest which may be deducted by corporations is referred to in the chapters on corporations and foreign corporations respectively.

Interest Paid by Banks. Interest paid by banks, banking associations, loan or trust companies on deposits may be deducted in full. For a discussion of the rulings on this point see the chapters on corporations and foreign corporations respectively.

[2] Anderson v. 42 Broadway Company, 213 Fed. 777. The Supreme Court in reversing the court on another point did not pass on the question of deducting interest accrued in one year and paid in another.

[3] T. D. 1960.

CHAPTER 30

DEDUCTION OF TAXES

In the case of individuals and domestic corporations the provisions for the deduction of taxes are the same. In the case of non-resident aliens and foreign corporations the taxes which may be deducted are limited to those assessed by the United States or its teritories or possessions or under the authority of any state, county, school district or municipality or other taxing subdivision of any state, paid within the United States, within the year, except such taxes as are not deductible by any class of taxpayers. For the special rulings applicable to non-resident aliens and foreign corporations see the respective chapters on those subjects.

Taxes Paid Within the Year. Under the 1913 Law and the 1916 Law the provisions for deducting taxes expressly limited deductions to taxes paid within the year. It was held by the Treasury Department that reserves for taxes could not be established as only such sums as were actually paid within the year could be deducted, that is, the aggregate of the amounts actually paid as shown by the cash book.[1] The provision of the 1916 Law allowing individuals and corporations to report on a basis other than that of actual receipts and disbursements, and the rulings by the Treasury Department there-

[1] Reg. 33, Arts. 156, 158.

under, would seem to permit, in the case of individuals or corporations reporting on an accrual basis, the deduction of the amount of taxes accrued on their books or the amounts reserved for the payment of taxes providing such amounts did not exceed the actual liability incurred during the year.[2]

Taxes Not Deductible. The law expressly provides that the taxpayer shall not deduct the amount of income taxes paid within the year under the 1916 or 1917 Laws and the amount of excess profits taxes paid to the Federal Government.[3] It is provided, however, that in assessing the tax for any year the Commissioner of Internal Revenue shall deduct the amount of the excess profits tax assessed for the year from the net income of that year before assessing the income tax.[4] The Act also provides that taxes assessed against local benefits shall not be deductible and that taxes paid by a corporation pursuant to a "tax-free" contract in its mortgages or bonds, shall not be deducted. In addition the Treasury Department holds that inheritance taxes are not deductible and taxes paid by a corporation for its stockholders have been held by the courts to be not deductible.

INCOME AND EXCESS PROFITS TAXES. Prior to the amendment of October 3, 1917, it was held that the income tax paid on income of one year, whether paid by the taxpayer or withheld at the source by the withholding agent, was properly deductible from the net income of

[2] T. D. 2433.

[3] Act of September 8, 1916, §§ 5, 6, 12 (a) and 12 (b), as amended by Act of October 3, 1917.

[4] Act of September 8, 1916, § 29, added by Act of October 3, 1917.

the following year.[5] The 1917 Amendment however, expressly provides that the Federal income taxes and the Federal excess profits taxes shall not be allowed as a deduction. Income taxes, or other taxes, levied by any state or government, other than the Federal Government, are proper deductions. In assessing the income tax, however, the net income embraced in the return is credited by the Commissioner of Internal Revenue with the amount of any excess profits tax imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer, and, in the case of a member of a partnership, with his proportionate share of such excess profits tax imposed upon the partnership.[6]

TAXES ASSESSED AGAINST LOCAL BENEFITS. Taxes paid pursuant to assessments levied by special districts, such as irrigation, reclamation, and drainage districts, for sidewalks in cities, street extension, grading, paving, étc., are held to be taxes assessed against local benefits and not allowed as deductions.[7] The taxes contemplated by the law as deductible are those which are paid to defray the expense of running the government. Where the taxpayer pays an assessment for something which will directly benefit him or his property it is not considered to be a tax in the true sense but rather in the nature of an investment in property.

TAXES PAID UNDER "TAX-FREE" COVENANTS. Where a corporation pays taxes for its bondholders under stipulations in bonds agreeing to pay the interest in full, re-

[5] T. D. 2135.

[6] Act of September 8, 1916, § 29, added by Act of October 3, 1917.

[7] T. D. 2090; Reg. 33, Art. 153.

gardless of any tax which it may be required to withhold or deduct, the amount of taxes so paid on behalf of such bondholders is not a proper deduction by the corporation.[8] The rulings on this point are contained in the chapter on corporations. The bondholder may, however, treat the amount so paid for him as his tax and deduct the same, if it is a tax levied by a state; if levied by the federal government he cannot deduct the amount as the law expressly prohibits deduction of the federal income tax. On the other hand, the bondholder should report as additional income the amount of tax so paid for him by the corporation.

INHERITANCE TAXES. A collateral inheritance tax, such as that levied under the laws of the State of New York, being a charge against the corpus of the estate is not considered to be such a tax as is allowed to be deducted under this provision of the law, either in computing the net income of the estate or the net income of the beneficiary.[9] Whether or not under any conditions an inheritance tax may be deducted has not been decided, but it seems that the theory adopted by the Treasury Department is that an inheritance tax is not in a true sense a tax which operates to reduce the income of the taxpayer for the year, and is rather the taking of a part of the corpus of the estate.

TAXES PAID BY CORPORATION FOR STOCKHOLDERS. Under the statutes of many of the states taxes are assessed against the stockholders of banks, the bank being required to pay the tax on behalf of its stockholders. In

8 T. D. 1948.

9 Letter from Treasury Department dated February 10, 1916; I. T. S. 1917, ¶¶ 352 and 661.

such cases it was held, under the 1909 Law, that the bank was not entitled to deduct the amount of taxes so paid as the tax was not a tax upon the bank or upon its property.[10] This rule was continued under the 1913 Law and the present laws, such taxes being held to be against the property of the private stockholders and not against either the corporation or its property.[11] The requirements of a state law that a bank shall pay for the stockholder cannot be construed as authority under which the bank may deduct the tax.[12] Where a statute requires the bank to pay the tax and gives it a lien upon the shares, the bank is not entitled to deduct the tax.[13] Where the statute gives the bank the option either to pay the tax out of its general funds or to collect the same from its stockholders, that fact does not change the character of the tax as a tax against the property of the individual stockholders, and the bank cannot deduct.[14] Even though the state statute makes no provision for recovery from the several shareholders of their proportional part of the amount so paid, the bank cannot deduct.[15] The absence of an express provision in the statute does not show that there is no such right of recovery, or that the intention was for the tax to fall ultimately upon the bank and not upon the stockholders.[16] As a general rule the

10 T. D. 1763.

11 The Northern Trust Company v. McCoach, 215 Fed. 991; T. D. 2135.

12 T. D. 2161.

13 Eliot National Bank v. Gill, 210 Fed. 833; aff'd 218 Fed. 600; National Bank of Commerce v. Allen, 211 Fed. 743; aff'd 223 Fed. 472; petition to the United States Supreme Court for writ of certiorari denied October 25, 1915.

14 Northern Trust Company v. McCoach, 215 Fed. 991.

15 First Nat. Bank of Jackson, Miss. v. McNeel, 238 Fed. 559.

16 Home Savings Bank v. DesMoines, 205 U. S. 503.

amounts of taxes so paid by a corporation for its stockholders are not collected from the stockholders, the corporation charging the taxes as an item of expense. Such taxes, however, should be reported by the stockholders respectively as taxes paid by them, according to their proportionate interests in the corporation.[17] The amount of the taxes so paid should also be treated as additional income from the net earnings of the corporation.[18] Where shares of stock are sold after the tax has been assessed, but prior to the time it is paid by the corporation on behalf of the stockholders, the one holding the stock on the date when a tax became due and payable is the one entitled to report the amount as a dividend and deduct the amount as a tax paid by him.[19]

Bank Guaranty Fund. Banking corporations which, pursuant to the laws of the state in which they are doing business, are required to set apart an amount, levied and assessed against them by the state authorities, as a "depositor's guaranty fund" may deduct the same from their gross income, provided the fund is set aside and carried to the credit of the state banking board or other duly authorized state officer, and may be withdrawn upon demand by such board or state officer to meet the demands of these officials in reimbursing depositors of insolvent banks, and, provided further, that no portion of the amount so set aside and credited is returnable,

17 T. D. 2135.

18 See Chapter 23.

19 Letter from Treasury Department dated February 25, 1916; I. T. S. 1917, ¶ 357. An earlier ruling in a letter dated March 2, 1915, held that the stockholder owning the stock at the time the taxes were assessed was the one entitled to the deduction, but the later ruling referred to above seems to indicate the present attitude of the Treasury Department.

under the existing laws of the state, to the assets of the banking corporation. In such cases the amount of the guaranty fund is no longer an asset of the bank, but is in the nature of a tax and as such is deductible.[20] Strictly speaking, such assessments are more properly deductible as an expense of doing business or, perhaps, as a loss, since the fund is intended to meet the losses of the banking business as a whole.

Taxes Paid by a Tenant. Where a tenant pays the taxes on property leased by him, he may consider the amount so paid as an additional payment of rent and may deduct it as an expense of carrying on his business.[21] To the landlord the amount is equivalent to an additional payment of rent and must be reported as such, but he may also deduct the amount, as, to him, it is a tax paid during the year by the tenant as his agent. The transaction is tantamount to a payment of the sum by the tenant to the landlord and a repayment by the landlord to the tenant, as his agent, for the purpose of satisfying the tax.

20 T. D. 2152.
21 T. D. 2090.

CHAPTER 31

DEDUCTION OF LOSSES

The law provides in the case of individuals that "losses actually sustained during the year, incurred in business or trade, or arising from fires, storms, shipwreck or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise, may be deducted, as also may debts due the taxpayer actually ascertained to be worthless and charged off within the year. In the case of the individual there is a limitation as to the amount of loss which may be deducted in transactions entered into for profit but not connected with his business or trade. This limitation and a discussion of losses incurred in trade is contained in the chapter on citizens and residents.[1] The rules discussed in this chapter are those applicable to corporations and individuals generally. In the case of corporations all losses actually sustained and charged off within the year and not compensated by insurance or otherwise may be deducted.[2]

Measure of Loss. In the case of loss of property or assets the loss must be based upon the difference between the cost value and the salvage value of the property or assets, including in the latter value such amount, if any, as has, in the current or previous years, been set aside

[1] See Chapter 4.

[2] Act of September 8, 1916, § 12 (a).

and deducted from gross income by way of depreciation.[3] When property is sold, the loss is the difference between the selling price and cost where the selling price is less than the cost.[4] In a case arising under the 1909 Law, the court said: "There seems to be no limitation provided in the act as to the amount of deductions to be allowed for losses actually sustained from any source during the year, and whether due to conditions of business, the sale of property, or anything else, and the court must, therefore, assume that the statute contemplated that the full amount of all losses sustained within the year would be allowed."[5]

Losses Must Be Actually Sustained During Year. The law provides in the case of individuals that the loss must be "actually sustained during the year" and in the case of corporations that the loss must be "actually sustained and charged off within the year." The Treasury Department holds that a loss to be deductible must be an absolute loss, actually sustained and ascertained during the tax year for which the deduction is sought to be made. It must be incurred in trade and be determined and ascertained upon an actual, a completed, a closed transaction. Losses sustained from the sale or dealings in personal or real property growing out of the owner-

[3] Reg. 33, Art. 124.

[4] T. D. 2090.

[5] Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206. In this case the court required the corporation to report as income all of its profits and permitted it to deduct all of its losses on the sale of property during the year, regardless of the fact that some of the property was purchased prior to the incidence of the tax, it appearing that the result would be the same if the gains and losses had been pro-rated as then required by the Treasury Department.

ship or use of, or interest in, such property will not be deductible at all unless they are ascertained, determined and fixed as absolute in the above sense within the taxable year in which the deduction is sought to be made.[6] The amount to be deducted as a loss should have in it no element of "depreciation" or "allowance for wear or tear" or "compensation from insurance or otherwise." The amount is to be an absolute and complete loss which has been actually sustained.[7]

Must Be Charged Off on the Books. In the case of corporations the loss may not be deducted unless it is actually sustained during the year and charged off on the books.[8] This rule would seem to apply with equal force in the case of an individual who keeps books, but one who does not keep books is not thereby deprived by the law of the right to claim a loss, except in the case of worthless debts.

FLUCTUATIONS IN BOOK VALUES. Fluctuations during the year in the value of capital assets, such as securities, for instance, even though evidenced by book entries do not constitute losses actually sustained. A loss may not be deducted until as a result of a completed, a closed transaction, the loss has been definitely ascertained and the amount it represents has irredeemably disappeared from the assets of the taxpayer.[9]

Reserves for Losses. Reserves to take care of anticipated or probable losses are not a proper deduction.[10]

6 T. D. 2005.

7 T. D. 2005.

8 Reg. 33, Arts. 124 and 158.

9 Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 259.

10 Reg. 33, Art. 126.

On the other hand, loss actually sustained during the year may be deducted although it is made good out of a fund which has been accumulated as an insurance reserve by the taxpayer.[11]

Loss of Capital. What the law contemplates as a deduction is the loss of capital, either by the sale of property or by the destruction or disappearance of property. It is, therefore, immaterial in what year the capital was created so long as the loss is actually sustained in the taxable year. It does not seem that the loss need necessarily be one connected with the business or trade of an individual, except in the case of losses resulting from sales or dealings in property, in which case the law expressly provides as to individuals that the loss must be incurred in his trade or business. Losses resulting from the destruction or loss of property by fire, storm or other casualty, or theft, seem to be deductible under the present language of the law whether or not the property is used in the taxpayer's business or trade.[12]

Losses of Income. Loss of income is not, generally speaking, a proper deduction. If, for instance, a debtor defaults in payment of interest, or a corporation fails to pay a regular dividend, or an employer fails to pay commissions or salaries, the amount of such items may not be deducted from other income during the year, as the income is reduced by the mere fact that the such sums are not included. If, however, the taxpayer has reported any such amounts as income for the taxable year, or a preceding year, as might be done in the case

11 Reg. 33, Art. 122.

12 See Act of September 8, 1916, § 5 (a), language of fourth deduction; also § 6 (a), language of fourth deduction.

of taxpayers reporting on a basis other than that of actual receipts and disbursements, the subsequent failure to collect the amounts so entered on the books may be treated as a loss when it is determined that the amount is not collectible. For a further discussion of this point see the paragraph below on worthless debts.

Losses in Business Transactions. The most frequent deductions for losses are claimed as a result of the sale of property. In such cases the loss occurs when the selling price is less than the cost. This is the converse of gain from the sale of property which is discussed in a preceding chapter.[13] The cost of the property is determined in the same manner whether the transaction results in a loss or a gain and the same rules apply with respect to property acquired prior to March 1, 1913.

Sale of Capital Stock. Where the capital stock of a corporation is issued for less than par, the amount of discount is not an allowable deduction to the corporation. Such a transaction is purely a capital transaction and the income of the corporation is not directly decreased by reason of the sale of the stock at a price less than its par value.[14]

Exchange of Stock. Where in a case of merger stockholders of one corporation exchange their stock for stock of the corporation resulting from the merger and receive a par value less than the par value of the old stock, it is held that the transaction constitutes a sale for income tax purposes, and that a deduction may be claimed for any loss measured by the difference between

13 See Chapter 20.
14 T. D. 2090.

the value of the old stock on March 1, 1913, (or the cost, if purchased subsequent to that date) and the value at which the same stock was given in exchange for stock of the company resulting from the merger. If the stock of the new corporation has a market value at or about the time of the merger, it has been indicated that the Treasury Department will hold the market value to be equivalent of cash in determining the selling price. Such losses of course, may be deducted, in the case of individuals, only to the extent that they do not exceed gains from other similar transactions during the year.[15]

Amounts Paid to Make Up Profits of Another Under Agreement. Contracts guaranteeing the payment of dividends or interest of one corporation by another are frequently made between corporations having close business relations. Whether or not amounts paid under such contracts or guarantees may be deducted, as a loss or as an expense of doing business, by the paying corporation has not been determined by the courts in this country. In England such payments have been held properly deductible as sums expended for the purpose of trade.[16] If the payment is made under an enforceable

15 Letter from Treasury Department dated March 9, 1917; I. T. S. 1917, ¶ 2122. See Chapter 16.

16 Moore v. Stewarts & Lloyds (1906) 8 Fraser 1129. In this case it was observed that the question was one of fact rather than of law. One company entered into agreement with another whereby in return for the right to nominate a majority of directors of the second company the first undertook to pay to the second such sums each half year as might be necessary to make up any deficit in the dividends on the latter's preferred shares. The court said, "If the agreement was entered into with a view to profit, as I think it was * * * then the annual charge to the respondent company is in my view a part of their business outlay or expenditure and is not subject to assessment."

contract there seems to be no reason why the amount should not be deducted either as loss or expense.

Voluntary Payment by Stockholders of Loss of Corporation. Assessments made by a corporation on its capital stock are regarded as an investment of capital and the amounts paid do not constitute allowable deductions to the stockholders.[17] This rule was held to apply in a case where a corporation showed a deficit at the close of the year and the stockholders agreed to make it good by the payment of voluntary contributions.[18]

Issue of Bonds Below Par. Where bonds are issued for a price less than par and are redeemable at par, the Treasury Department has held that the loss, which must eventually be sustained on redemption of the bonds, may be deducted by pro-rating the amount of the discount in accordance with the life of the bond.[19] The intention of this ruling is to allow corporations selling their own bonds at a discount to pro-rate the discount over the life of the bonds and to deduct from gross income each year an aliquot part of the discount, determined in accordance with the number of years which the bonds have to run from the date of issue. If, however, the bonds were issued prior to the incidence of the tax and, at that time, the entire amount of the discount was charged to profit and loss, the issuing corporation may not claim a pro-rata allowance for such discount for the years subsequent to the incidence of the tax.[20] Charging off the discount

17 T. D. 2090.

18 Letter from Treasury Department dated February 21, 1916; I. T. S. 1917, ¶ 340.

19 Reg. 33, Art. 135.

20 T. D. 2161.

prior to the incidence of the tax constitutes a closed transaction and such transaction cannot be re-opened for the purpose of reducing the taxable income of the corporation[21] The court has held that if a loss sustained by a corporation selling its own bonds at a discount is an expense, it will not be paid until the maturity of the bonds and should, therefore, be pro-rated over the life of the bonds, and not deducted in full in the year in which the bonds were issued.[22]

Purchase of Bonds for Retirement. Where bonds have been issued at par, under the terms of an indenture requiring the corporation annually to purchase and retire a certain number of the bonds, and the corporation is required to purchase such bonds for retirement in the market, the difference between par value of the bonds and the amount paid for the bonds on retirement is deductible as a loss. If the bonds were issued at a premium, the loss to be claimed should be the difference between the price at which the bonds were issued and the price at which they were purchased for retirement, unless the amount of premium received on the original sale of the bonds was accounted for as income in the year in which the bonds were sold, in which case the difference between the par value and the purchase price may be deducted. In the event the bonds were issued at a discount, and the discount was charged against the earnings of the year in which issued. the difference between the par and the purchase price may be deducted as a loss; but if the discount on the bonds was pro-rated over the life of the bonds and the annual proportion charged against the yearly income, the

21 T. D. 2137.

22 Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

amount to be charged off, as a loss, should be the difference between the price at which the bonds were issued and the purchase price minus an allowance for the sums that have been charged off annually on account of the pro-rated discount.[23]

Bonds Purchased Above Par. Where bonds have been purchased above par it seems, under the present law, that no deduction can ordinarily be made for the loss of the amount of the premium until the bonds are either sold in the market before maturity, or until the principal sum is received at the time of maturity. In either case the losses will be the difference between the amount paid and the amount received. Where, however, a taxpayer reports on a basis other than of actual receipts and disbursements it seems that this sum may properly be deducted in proportionate amounts each year as amortization.[24]

Loss by Destruction or Disappearance of Property. The law expressly provides, in the case of individuals, that the loss arising from fires, storms, shipwrecks, or other casualty, or theft, may be deducted in the year in which the loss is sustained. This kind of loss is allowed to corporations without specific mention, as with respect to corporations all losses are deductible. In the case of non-resident aliens the law permits the deduction of all such losses of property within the United States, and this

23 Letter from Treasury Department dated March 23, 1915; I. T. S. 1917, ¶ 1326.

24 Under the 1909 Law it was held that where bonds were purchased at a rate above par a proportionate amount of the premium might be deducted each year on account of amortization. T. D. 1727.

is apparently intended also in the case of foreign corporations, although the language of that provision seems to limit the losses to business or trade conducted by the foreign corporation within the United States.[25] In all cases the law provides that the deduction may be made only when such losses are not compensated for by insurance or otherwise. The intent seems to be to permit a deduction of the losses to the extent that the taxpayer is not compensated by insurance or otherwise, and that if he is compensated for part of such loss he may deduct the part for which he is not so compensated. In claiming a loss due to the destruction of property the salvage value of the property must be considered as a partial compensation to be deducted from or not included in the amount claimed as deduction. Further, if depreciation has been claimed from time to time upon the property so destroyed, the aggregate amount of such depreciation allowance should be deducted from the cost of the property in ascertaining the amount of the loss. In this, as in all other cases, the measure of the loss is the difference between the cost of the property and the amount received as compensation. The value of the property at the time of the loss is not intended to be the measure of the loss, and it is not clear whether or not the value on March 1, 1913, may be taken instead of the cost, where the property was acquired prior to that date, as is expressly permitted by law in sales of property.[26]

LOSS OF LIVE STOCK. Where a farmer has purchased live stock which afterwards dies from disease or injury, or is killed by order of government authorities, and the

[25] See Act of September 8, 1916; §§ 5 (a), 6 (a), 12 (a) and 12 (b).

[26] See Chapter 20.

cost thereof has not been claimed as an item of expense,[27] the actual purchase price of such stock, less any depreciation which may have previously been claimed, may be deducted as a loss. Any other property destroyed by order of government authorities may in a like manner be claimed as a loss; but if in any case reimbursement is made by the government in whole or in part on account of the stock killed or property destroyed, the amount so received must be reported as income for the year in which reimbursement is made,[28] that is to say, only net loss is allowable as a deduction.

Shrinkage or Deterioration in Storage. Loss due to shrinkage or deterioration of produce in storage is not allowed as a deduction. Such shrinkage or deterioration is reflected in the selling price when the goods are sold and correspondingly reduces the net income at that time.[29]

Worthless Stock. A loss is none the less actual because an individual cannot divest himself of the possession of worthless stock by sale, but that condition alone does not give the loss in question such a character as appears to the Treasury Department to have been contemplated by the income tax law.[30] However, if the stock has even the slightest value so that it may be sold for any amount it seems the loss may be deducted as it is then the result of a closed transaction. It seems, also, that the loss would be properly deductible if the corpora-

27 A farmer may deduct as an item of expense the cost of live stock purchased for re-sale.

28 T. D. 2153.

29 T. D. 2153.

30 T. D. 2135.

tion has been dissolved, or if its charter has been forfeited since then there is a final ascertainment of the loss.

District Irrigation Bonds. District irrigation bonds as a rule, if not always, are a lien upon the real estate affected by the irrigation project and until the corporation has taken such steps as are necessary to protect its rights and enforce the collection of the bonds it does not appear that the corporation would be warranted in writing out of its assets and deducting from income, as a loss, the face value or any other arbitrarily ascertained amount representing a loss or shrinkage in the value of such bonds.[31]

Worthless Debts. For the purpose of deduction as losses, debts are divided into two classes, (a) those which represent to the creditor a return of capital and (b) those which represent unpaid income. The former may be deducted regardless of when the debt became due and payable, but the latter, such as uncollected wages, salaries, rents, interest and items of similar taxable income, may not be deducted, if the debt became due on or after March 1, 1913, unless the amount thereof has been reported as income; but if the debt became due and payable prior to March 1, 1913, it may be deducted in any event.[32] The losses which may be deducted are losses of capital; income on which the tax has been assessed assumes the status of capital, and income which became due and payable before the incidence of the tax is capital to the taxpayer although it may be received thereafter. The mere failure to receive income does not

31 T. D. 2152.
32 T. D. 2224.

warrant a deduction, as the omission of such amounts operates, in itself, as a reduction of the tax.

MUST BE CHARGED OFF ON BOOKS. The law expressly provides in the case of individuals that worthless debts must have been "charged off" in the year in which they are claimed as a deduction. In the case of corporations such deduction must also be evidenced by entry on the books, as must all losses.[33]

WHEN DEBTS MAY BE CONSIDERED WORTHLESS. Where the debtor is an individual, it is not necessary that an unsatisfied judgment shall exist or a judicial determination be reached in order that the creditor may secure the benefit of a deduction on account of a debt which he considers worthless and uncollectible; but taking into consideration the time the debt is over-run and the financial condition of the debtor, it is required that it be shown beyond a reasonable doubt that the debt is worthless and uncollectible. If the debtor is a corporation, possessed of assets, the debt cannot be claimed as a deduction except for the year in which the debtor corporation's affairs are finally closed and its receiver in bankruptcy discharged. Where in any case a creditor to protect himself from total loss enters into a compromise agreement under the terms of which he accepts a part payment of the debt and releases the debtor from payment of the balance, the unpaid portion may be claimed as a deduction.[34] Whenever the debtor is legally discharged from his obligation either by the running of the statute of

33 Act of September 8, 1916, §§ 5 (a) and 12 (a), Reg. 33, Art. 125.

34 Letter from Treasury Department dated October 16, 1917; T. T. S. 1917, ¶ 2441.

limitation, by bankruptcy proceedings, by accord and satisfaction, by formal release, or by any other method, it seems the creditor may claim the amount of loss which he sustains as a deduction. As indicated by the ruling above it may be possible under other conditions to deduct the amount of a debt but the circumstances must be such as to indicate beyond doubt that the debt cannot be collected. A mere voluntary forgiveness of the debt would not make the amount thereof an allowable deduction since such voluntary action on the part of the creditor would be tantamount to a gift.

Unpaid Instalments. When property has been sold on the instalment plan and the total amount of notes taken for the selling price has been treated as the equivalent of cash in reporting income, if subsequently instalment payments are defaulted, there may be charged off as bad debts the amount of such unpaid instalments, less the salvage value of the property re-possessed.[35]

Loss Due to Adverse Judgment. In a case where a corporation was sued for infringing a trade name covering a period ending in 1912, and judgment was obtained against it in 1916, the Treasury Department held that the amount of this judgment should be prorated over the period ending in 1912 according to the income of each year. Such part as was found by this method to be applicable to the income of the corporation for the period 1909 to 1912 would be referable to those years, but no part of this sum would be deductible as a loss in the return of income for 1916. The same corporation also paid, in 1916, an additional sum, as consideration for dismissal of a pending suit for interest on the above judg-

[35] T. D. 2090.

ment from the date of the decision of the court to the date of payment and for the unrestrained use of the trade name in question. It was held by the Treasury Department that if this amount could be segregated between interest and use, it might be prorated the same as in the other case, for the period subsequent to 1912, and such part thereof as would be found applicable to the 1916 income would be deductible under the head of business expense and interest respectively. If no segregation could be made the entire amount might be treated as business expense.[36] This ruling was made, apparently, on the theory that the loss was not sustained in 1916, but in the respective years when the income was earned, but the language of the law would better support a conclusion that the entire loss was sustained in the year the adverse judgment was rendered.

[36] Letter from Treasury Department dated February 9, 1917; I. T. S. 1917, ¶ 2009.

CHAPTER 32

DEDUCTION OF ALLOWANCE FOR DEPRECIATION

In the case of individuals the law permits a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade of the individual. Property not used in his business may not be included in the annual allowance for depreciation. In the case of non-resident aliens, the property must be within the United States and used or employed in the business or trade of the non-resident alien. In the case of corporations, the allowance is also for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade, limited in the case of a foreign corporation to the business or trade conducted by it within the United States.[1] The purpose of allowing a deduction each year for depreciation is to take care of the certain loss of property which takes place from year to year, due to wear and tear. The property must be used or employed in the business or trade of the taxpayer. No depreciation is allowed on a dwelling house occupied by the owner as a private residence.[2]

Property Must Be Subject to Wear and Tear. Depreciation as an allowable deduction in ascertaining an-

1 Act of September 8, 1916; §§ 5 (a), 6 (a), 12 (a) and 12 (b).
2 T. D. 2153.

nual net income for the purpose of the income tax is not to be confused with the deduction for loss. The depreciation permitted to be taken as a deduction is the value assigned to the deterioration of physical improvements or assets such as are susceptible of having their value lessened through wear and tear.[3] Assets of any character which are not affected by use and wear and tear are not subject to the depreciation authorized by the law.[4]

LOSS IN RENTAL VALUE OF BUILDINGS. The allowance for depreciation is to make good the wear and tear suffered by property during the tax year which, in the case of a building, means the physical deterioration thereof. It does not take into account depreciation in value due to a loss in rental value because of the construction of more modern buildings with improved facilities or due to change in the neighborhood.[5]

REAL ESTATE. Real estate, as such, and as distinct from the improvements thereon, is not reduced in value by reason of wear and tear and an allowance for depreciation in the case of real-estate does not apply to the grounds, but is intended to measure the decline in the value of the improvements due to wear and tear of such improvements. In determining the cost of real estate, in most cases, no segregation is made of the cost of the building as separate and distinct from the cost of the ground. In such cases the value of the ground should be appraised and deducted from the total cost of the

[3] T. D. 2005.
[4] T. D. 2137.
[5] Cohen v. Lowe, 234 Fed. 474..

property and the depreciation based upon the remainder.[6]

Farm Buildings and Machinery. Depreciation may be claimed on farm buildings and farm machinery (but not on the dwelling occupied by the owner) and also on other physical farm property subject to wear and tear.[7]

Stock for Breeding Purposes. A farmer may claim depreciation on live stock purchased for breeding purposes, but should not claim depreciation on stock raised or purchased for resale, as the cost of the latter is an expense of his business, while the cost of the former is not deductible as an expense.[8]

Wearing Apparel. If costumes purchased by actors and actresses are used exclusively in the production of a play and are not adapted for occasional personal use, and are not so used, deduction may be claimed on account of such depreciation in their value as occurs during the year on account of wear and tear arising from their use in the production of the play, or a loss may be claimed if they become obsolete at the close of the production.[9]

Merchandise. Depreciation computed on total invoice value of merchandise in stock is not an allowable deduction, since any loss due to shrinkage in the salable value of the merchandise will be reflected in the sales when the merchandise is disposed of, and inventory is

6 T. D. 2137.
7 T. D. 2153.
8 T. D. 2153.
9 T. D. 2090.

required to be taken at cost.[10] This ruling is contrary to the approved practice of taking inventory at cost or at market prices, whichever is the lower. It seems that the Government would not lose in the long run by recognizing this accepted practice of conservative business men, as the loss on account of marking down inventory would result in a larger gain when the goods were sold. Under the provision of the 1916 Law the Commissioner has power to recognize such a practice and to permit taxpayers to report on that basis.

GOOD WILL. Good will does not represent a value attaching to physical property, and is held to be an intangible asset whose value, separate and apart from the business with which it is connected, is not capable of determination. For the purpose of the income tax, it is capable neither of appreciation or depreciation, hence no claim for depreciation can be made for the loss or partial disappearance of good will.[11]

STOCKS AND BONDS. Since there is no wear and tear in the case of stocks and like securities, no deduction can be made on account of fluctuations in their market value.[12]

NO ALLOWANCE FOR OBSOLESCENCE. The deduction for depreciation does not contemplate any provision for obsolescence, but is limited to the creation of a reserve fund out of which the loss due to use, wear and tear, may be compensated. It is not possible in advance to

10 See Instructions on Form 1031, return of net income of corporations.

11 T. D. 2137; Reg. 33, Art. 136.

12 T. D. 2005.

determine when a piece of machinery, equipment or even a building will become obsolete. Since obsolescence cannot be anticipated, an annual deduction will not be permitted to take care thereof. If it happens that the property becomes obsolete or worthless before its estimated probable life shall have expired a deduction representing the difference between the cost of the property and amount previously charged off on account of depreciation may be deducted, as a loss, in the year in which the property is determined to be obsolete.[13] In the earlier rulings the Treasury Department held that depreciation applied to tangible property subject to wear and tear, exhaustion or obsolescence.[14] But it seems that the position now taken is that obsolescence is not contemplated by the provision of the law relating to depreciation, and that no other provision of the law permits an annual allowance with respect thereto, since neither the time when property may become obsolete, nor the loss, when the stage of obsolescence is reached, can be determined with any degree of certainty in advance.

Depreciation Based on Cost of Property. The amount which may be claimed as the total allowance for depreciation, that is, the aggregate of the several annual allowances is the cost of the property, not its value at any particular time. Unearned increment will not be considered in fixing the value on which depreciation shall be based.[15] The theory on which depreciation is based is that the individual shall have returned to him at the time the property is exhausted an amount equivalent to his in-

13 Letter from Treasury Department dated September 19, 1916; I. T. S. 1917, ¶¶ 1365 to 1367.

14 Reg. 33, Art. 129; T. D. 2005; T. D. 2077; T. D. 2090.

15 Reg. 33, Art. 146.

vestment in such property, in the form of annual allowances which have not been taxed. The cost of property is ascertained without difficulty in most instances, but where property has been taken over by a corporation in exchange for stock a difficulty arises and it seems that the ruling with respect to the sale of assets would apply, namely, that where the property has been taken over in exchange for capital stock of a par value greatly in excess of the true value of the property, or if the true value of the property was greatly in excess of the par value of the stock issued for it, a careful estimate of the value of such property at the time is was acquired may be fixed and set up as the value representing the cost of the property.[16]

VALUE OF PROPERTY AS OF MARCH 1, 1913. In claiming depreciation the amount to be taken care of is always the amount of capital invested in the particular physical property, and the value of such property as of March 1, 1913, or as of any other date, is not to be taken into consideration.[17] The soundness of this ruling may be questioned. In the case of the sale of property, the law expressly provides that where the property was acquired prior to March 1, 1913, the fair market price or value of such property on March 1, 1913, shall be the basis for determining the amount of the gain or loss and the same basis is fixed by the law for claiming the allowance for depletion. It seems that the rule should apply with equal force in the case of depreciation even though the law is silent. If the property subject to depreciation increased in value between the time of purchase and March 1, 1913, the taxpayer should be

16 T. D. 2161.
17 T. D. 2446.

permitted to add the increase in value to the original cost and to compute depreciation on that basis, so that he might have returned to him, at the time the property is exhausted, an aggregate of allowances amounting to the value of the property on that date, which value was capital to him at the incidence of the tax.[18]

Book Values. The book value of property has no relation to the allowance which may be claimed for depreciation, unless the book value states the cost of the property. Fluctuations in book values cannot be taken into consideration. Either the book value or the intrinsic value of property on which depreciation is claimed may increase or decrease without affecting the rate of annual allowance. No depreciation may be claimed because of arbitrary changes in the book value of securities and like assets, the gain or loss with respect to which will be determined only when such assets mature or are sold or disposed of.[19] The fact that bonds and similar securities have been written off at the direction of the Comptroller of the Currency or a state banking department is not material. A mere book entry does not constitute either loss or gain for the purpose of the income tax. The fact that bonds were written off does not necessarily imply that they are a total loss nor is this act a conclusive proof that any loss occurred during the year for which the return is made.[20]

18 See Act of September 8, 1916; § 2 (c), § 5 (a), § 10, § 12 (a) and (b); also Doyle v. Mitchell, 235 Fed. 686; 149 C. C. A. 106.

19 T. D. 2077.

20 T. D. 2152. If, however, the taxpayer reports on a basis other than that of cash receipts and disbursements it would seem that the Commissioner of Internal Revenue has authority to permit the changes in book values of securities to be taken into consideration as a part of the income or loss for the year.

Annual Allowances Measured by Life of Property. After the cost of property subject to depreciation has been ascertained, the annual allowance is determined by dividing the cost by the probable number of years constituting the life of the property, the result being the amount which may be deducted annually. The life of the property necessarily depends upon its character, the use to which it is put and the conditions under which it is used. These elements being taken into consideration taxpayers are expected, as a result of experience and observation, very closely to approximate the number of years constituting the life of the property.[21] If, after property has been used for a certain purpose, it is put to another use by which it deteriorates more rapidly the allowance for depreciation may be increased accordingly. In estimating the life of the property it is assumed that the owner will make such repairs and renewals as are necessary to prevent undue deterioration. In the case of a building, for instance, depreciation is to be based upon the life of the building in the sense of the number of years the building will remain in a condition to be habitable for the use for which it was constructed and used, and not merely the number of years it will stand without being condemned and torn down. In determining the life of the building it is assumed that the owner will keep it in good repair.[22]

INCIDENTAL REPAIRS TO PROPERTY ON WHICH DEPRECIATION IS CLAIMED. Such ordinary incidental repairs as keep the property in an operating condition should not be charged to depreciation reserve, but the cost should

21 T. D. 2152.
22 Cohen v. Lowe, 234 Fed. 474.

be charged to expense. A building or a piece of machinery or other equipment, as a whole, may deteriorate in value and usefulness by reason of wear and tear regardless of the fact that certain minor component parts may be renewed, restored or replaced. The depreciation deduction contemplates the creation of a fund that will renew, restore or replace the original property, when it has become worn out or exhausted, regardless of the renewal and restoration of parts that may have been made in the meantime. Hence, in addition to the depreciation deduction, the expense of incidental repairs which do not add to the value of the property, but merely keep it in an operating condition, may be deducted as expense in the year in which the repairs are made.[23]

RENEWALS TO PROPERTY. It is possible in some instances that worn out parts of a machine or similar equipment may be renewed, one after another, until the original machine or equipment is swallowed up in the renewed parts and the machine or equipment is then in as good operating condition as it was originally. In such cases, if the cost of renewed parts is charged to operating expense, no deduction on account of depreciation should be claimed as to such machine or equipment. Thus, in the case of pipelines, by replacing one joint of pipe after another all may be replaced and, if the expense of replacements is deducted as an operating expense, no depreciation fund should be set up for the purpose of restoring the pipeline as a whole. On the other hand, if a reserve is set up to cover property that may be renewed or restored part by part until the whole is renewed,

23 Letter from Treasury Department dated September 19, 1916; I. T. S. 1917, ¶¶ 1356 to 1358.

the cost of the renewed part should be charged to the depreciation reserve fund and not to expense.[24]

Rate of Depreciation. The annual allowance for depreciation, is required by law to be "resonable." No fixed rates are prescribed. The rule which has been established contemplates that the taxpayer shall determine his annual deduction by dividing the cost of the property by the probable number of years constituting its life, in the manner indicated above, the result being the amount which may be deducted annually.[25]

DEPRECIATION OF APARTMENT HOUSES. In the case of an apartment house it was held by the court that where the Government had allowed 3% of the cost as annual depreciation the burden was on the owner to show that the amount so allowed was too small, the court considering the rate to be reasonable in this case.[26]

Annual Allowance Must Be Entered on Books. A reasonable allowance for depreciation must be determined upon a basis of the cost of the property and the

[24] Letter from Treasury Department dated September 19, 1916; I. T. S. 1917, ¶¶ 1359 to 1361.

[25] T. D. 2152. A collector who told taxpayers in his district that the amount of depreciation on frame buildings was limited to 3%, and in case of brick buildings to 2%, was informed by the Commissioner of Internal Revenue that while these rates might not be far from a reasonable and fair measure of depreciation sustained on such buildings, the rates should not be considered as the "limit," as the probable number of years constituting the life of the building might make the rate more or less than the figures stated. Letter from Treasury Department dated May 22, 1916; I. T. S. 1917, ¶ 1381.

[26] Cohen v. Lowe, 234 Fed. 474.

probable number of years constituting its life. The amount of allowable depreciation deduction, thus ascertained, should be credited to a depreciation reserve account, against which account will be charged the cost of renewing or replacing the property with respect to which depreciation is claimed.[27] Such depreciation liability must be reflected in the annual balance sheet.[28] A journal entry alone is not sufficient.[29] Neither the 1909 Law nor the 1913 Law required that in order to secure a deduction for depreciation the amount claimed should be written off. It was, nevertheless, held by the Treasury Department that a depreciation deduction, in order to be allowable, must be so entered upon the books of a corporation as to constitute a liability against its assets. Where a corporation had claimed depreciation without writing off the amount on its books the corporation was permitted to reopen its books, if it so desired, and make such entries as would constitute the amount a liability against the assets of the company, and a charge against the income of the year in which the return was made. Revenue agents were directed to give the taxpayer sufficient time to make such correct entries before the claim for depreciation was disallowed. If a corporation refused or neglected to reopen its books and write off the depreciation claimed in a return the amount claimed was disallowed. If the correct entries were made for preceding years, the amount entered for each year had to be such as would have been entered at the time the books

[27] Letter from Treasury Department dated September 19, 1916; I. T. S. 1917, ¶ 1355; Reg. 33, Art. 130.

[28] Letter from Treasury Department dated February 12, 1915; I. T. S. 1917, ¶ 1405.

[29] Letter from Treasury Department dated May 18, 1916; I. T. S. 1917, ¶ 1428.

were closed.[30] In a later ruling it was held that, under these acts, writing off of depreciation would not be insisted upon in the adjustment of returns filed for the years 1909 to 1915 inclusive.[31] The 1916 Law does not expressly require individuals to enter on their books the annual allowance for depreciation but with respect to domestic corporations it does expressly provide that all losses, including the allowance for depreciation, must be "charged off" within the year.[32] As to foreign corporations the Law is silent.

Reserves for Depreciation. In early rulings it was held that depreciation set up on the books and deducted from gross income could not be used for any purpose other than making good the loss sustained by reason of the wear and tear or exhaustion of the property and that if any portion of the depreciation set up was diverted to any purpose other than making good the loss sustained by reason of such depreciation the amount would be disallowed. It was also held that the invest-

30 Letter to Collectors dated August 27, 1914; I. T. S. 1917, ¶ 1368.

31 T. D. 2481, dated April 10, 1917. In the meantime the courts had held, under the 1909 Law, that the contention that no allowance for depreciation could be claimed unless it was entered on the books of the company, recorded from time to time, was without force (U. S. v. Nipissing Mines Co., 202 Fed. 803) and that the fact that a deduction was incorrectly carried on the books in surplus account did not justify the Government in disallowing it. Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704. The Supreme Court of the United States declined, in Strattons' Independence Limited v. Howbert, to answer the question as to whether or not a book entry was necessary, since the question was not properly brought before the court in that proceeding.

32 See Act of September 8, 1916, §§ 5 (a), 6 (a), 12 (a) and 12 (b).

ment of depreciation reserve funds in additions, betterments and improvements was not contemplated by the law.[33] The present ruling holds that the words "charged off," in the statute, mean that the allowance for depreciation is to be credited to an appropriate reserve account and be carried as a liability against the assets, to the end that when the total of these credits equals the capital investment account no further deductions will be allowed. There is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed, or in restoring the capital investment in the depleted assets. The depreciation reserve may be invested in assets of any kind.[34]

Deduction by Lessees. Where a corporation issues all of its capital stock for cash and expends this capital in the erection of a building upon a plot of land which it holds under lease, the lease requiring the lessee to erect, operate and maintain a building and providing that at the end of the lease the building and improvements then on the land shall be surrendered to the lessor without compensation, the lessee may claim depreciation on the building through annual deductions based on the cost of the building and its estimated life, or the life of the lease, whichever is the shorter.[35] This rule would hold true in the case of any tenant who invests capital in permanent improvements or buildings on the real estate of the landlord, unless it is expressly provided by

[33] Reg. 33, Arts. 132 and 133, T. D. 2137.

[34] T. D. 2481.

[35] Letter from Treasury Department dated February 27, 1917; I. T. S. 1917, ¶ 2064.

contract that title to the property shall remain in the tenant after the lease expires; in the case contract so provides, the annual depreciation would be measured by the life of the property without regard to the period of the lease.

CHAPTER 33

DEDUCTION OF ALLOWANCE FOR DEPLETION OF OIL AND GAS DEPOSITS

The law provides that there may be deducted "in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, to be ascertained not by the flush flow, but by the settled production or regular flow."[1] It is also provided that when the allowance so authorized is equal to the capital originally invested, or, in the case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made. The provisions for depletion are the same with respect to corporations and individuals. The Treasury Department holds that this provision of the law applies only to the owner of the property from which oil or gas is produced, and that the lessee is not entitled to any claim for depletion since one operating under a lease has no capital invested in the property. This seems to be a very narrow construction of the language of the law. But the theory on which the Treasury Department proceeds is that whatever capital the lessee may have invested is not in the deposit but in the physical property used in operating the property on which depreciation may be claimed, or, if a "bonus" has been paid, that it is in the nature of advance payment of royalties, and the amount thereof may be ratably dis-

[1] Act of September 8, 1916, § 5 and § 12.

tributed over the life of the lease or over the productive life of the property, as is further indicated in a following paragraph on the subject of lessees. A broader construction of the law would, however, lead to the conclusion that the claim of allowance for depletion should be made with respect to the capital invested in a natural resource either by the owner, the lessee, or the operator all of whom may have capital invested in the deposit. The amount a lessee pays the owner for the right to operate a property and produce the oil or gas is capital invested by him in the natural resource. The amount a successor of a lessee pays the lessee for the rights under a lease is capital invested by such successor. A lessee who pays nothing but annual royalties to the owner may also have capital invested in the natural deposit, the amount in such case being the total of all the amounts expended in developing the property before it begins to produce (unless any such amounts are deducted from his net income from other sources), and such amounts as are expended after the property begins to produce and are not charged to expense. The Treasury Department does not disallow an annual claim for these amounts but does not permit them to be claimed under the head of depletion. The right to claim the allowance for depletion is limited strictly to the owner of the property from which the oil or gas is produced.

Depreciation Not Included in Depletion. The depletion allowance has no relation to the allowance for depreciation due to exhaustion, wear and tear of the physical property used in the discovery or removal of the natural deposit. The allowance for depreciation should be computed separately and apart from the allowance for depletion, and should be determined according

to the rules laid down with respect to depreciation. Thus, depreciation would be allowed on rigs, tools, machinery of all kinds, pipes, casing, and other equipment necessary to the operation of the wells or the field. Such deduction for depreciation may be taken by the owner of the physical property whether he be the owner, the lessee, or the operator of the natural deposit with respect to which depletion is claimed.[2]

Oil Wells. The same rule is laid down by the 1916 Law for computing depletion of oil wells and of gas wells. Under the 1909 Law the regulations, prescribing the method for claiming depletion with respect to each, were different. With respect to oil wells the depletion was, at that time, based upon a unit value per barrel, as is further indicated by the paragraphs at the close of this chapter.

Gas Wells. Under the 1916 Law the depletion for gas wells is measured by the reduction in flow and production in the same manner as in the case of oil wells. Under the 1909 Law the Treasury Department ruled that depreciation of gas wells could be made on the basis of reduction in rock pressure, or reduction of volume, at the option of the tax payer. The present law has been criticized by owners of gas wells on the ground that to determine depletion by gauge of the open flow of each well necessitates a waste of gas in order to obtain an accurate test, and it is contended that the method of using rock pressure would more nearly represent the flow from year to year than any test of volume. A gas well is not, like an oil well, usually operated to get the greatest production at all times. Depletion in

[2] T. D. 2447.

the case of gas wells is sometimes measured by the use of a minute pressure volume gauge, which, though not accurate, is valuable for comparative purposes. Under the present law, however, the Treasury Department recognizes only one measure of depletion and that is by the expensive process of determining the reduction in flow.

Owner Entitled to Claim Deduction. The rulings are that the owner of the gas or oil well may deduct annually "a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow." The owner who claims the deduction must be the owner during the period for which the deduction is claimed.[3] Lessees are not permitted to claim an allowance for depletion as they have no capital invested in the property.

Basis of Deduction. The amount on which the annual allowance is based is either (a) the amount originally paid for the property (not including the cost of machinery, buildings, or other physical property subject to wear and tear connected therewith) or (b) the fair market value of the oil or gas deposits on March 1, 1913, if the property was purchased prior to that date. When this amount has been reached by a series of annual allowances no further allowance is permitted for depletion. In order to determine when allowances for depletion shall cease, the owner of the property must keep an accurate ledger account, in which shall be charged the value or cost, as the case may be, of the property with respect to which the allowance is claimed. This account must be credited annually with the amount allowed as a de-

[3] T. D. 2447.

pletion deduction, and when the account balances no further allowances may be claimed. The cost, or the value as of March 1, 1913, must be fixed and set up on the books before the first allowance with respect thereto is claimed. Once fixed, it cannot be changed, notwithstanding the fact that the quantity of oil or gas was underestimated at the time the value was fixed or at the time the property was acquired.[4]

CAPITAL ORIGINALLY INVESTED. This phrase, as used in the law, is held to mean the actual cost of the property containing the natural deposit, but not the cost of any physical property connected therewith on which depreciation may be claimed.[5]

FAIR MARKET VALUE AS OF MARCH 1, 1913. Where the property was purchased prior to March 1, 1913, the fair market value as of that date should be taken instead of the cost. Such fair market value must be determined by each owner, upon such basis as will not comprehend any operating profits, the estimated value in all cases being subject to the approval of the Commissioner of Internal Revenue. The estimate should be an estimate of the price at which the property as an entirety might have been sold for cash or its equivalent on March 1, 1913.[6] Although the Treasury Department does not recognize the right of a lessee to claim depletion, it seems that where a lessee had a leasehold interest on March 1, 1913, he should be permitted to claim depletion on the value thereof at that time, as such value repre-

4 T. D. 2447.
5 T. D. 2447.
6 T. D. 2447.

sented capital to him at the incidence of the tax, on which he sustains a loss as the deposit is removed.

Rate of Annual Deductions. The annual deductions must be reasonable in amount; that is, such sums as will in the aggregate equal the capital originally invested (or the value on March 1, 1913) at or about the time the deposit is exhausted. The allowance is for actual reduction in flow and production during the year and not on a unit value basis as in the case of mines. The Treasury Department has ruled that this decline in flow and production should be reduced to a percentage basis and a like percentage of the capital invested (or value on March 1, 1913) constitutes the allowable deduction for the year. That is, if the decline in the flow and production during the year of ten wells, costing $100,000, has been 5%, as compared with the production and flow indicated by a test made at the beginning of the period, then 5% of $100,000 will be the allowance for that year. Where the property contains more than one well, the percentage of reduction for each well may be ascertained, in which case the average percentage of reduction for all the wells would determine the percentage of original cost or value which may be taken. The depletion deduction in all cases until the capital is extinguished will be such percentage of the capital as a reduction in the flow and production of one year is a percentage of the flow or production of the previous year.[7] It should be noted that by this method of determining depletion, no allowance can be claimed so long as the oil or gas wells show no reduction in the settled or regular flow. Thus, a well may show only a 5% reduction in flow annually for two years, and in the third year may stop altogether; the

[7] T. D. 2447.

ninety per cent loss in the third year may be deducted, but is of no avail unless the taxpayer has other income sufficient to offset it. A more equitable basis would be to allow a reasonable deduction during the years that the well produces its maximum, on a per unit value basis, as in the case of mines, the allowance stopping when the capital has been returned to the owner.

REDUCTION OF PRODUCTION AND FLOW. The reduction of production and flow in the case of a fully developed territory, where no new wells are being drilled, may be ascertained by a comparison of the quantity produced during the year with the quantity produced during the preceding year. That is, where the production in one year is 50,000 barrels and the production in the following year is 47,500 barrels, this would indicate a reduction in production of 2,500 barrels or a decline of 5%. Applying this rate to the capital or value, would determine the amount of the annual allowance. Where a property contains more than one well, the reduction may be determined with respect to each well, or with respect to groups of wells, or with respect to all the wells in the field or territory owned by the taxpayer. The taxpayer has the option of measuring the reduction by individual wells, or groups of wells, or the entire field, but is required to state the method pursued, in a statement to be attached to the return of annual net income. If wells are not so situated that their flow and production may be assembled in order to test and ascertain the reduction, as a group, it is necessary to take an accurate gauge of each well at a certain same period of each year and by comparing this gauge with that of the previous year determine the percentage of reduction applying to each well. This having been done, the average percentage

reached for all the wells on the property will be used in ascertaining the amount of the deduction. If the depletion deduction is computed for a group of wells or an entire field and new wells are drilled, the flow from the new wells may offset the reduction of the other wells, but no allowance can be claimed so long as the flow of the unit, that is, the group of wells or the entire field, is as great for the year as it was for the preceding year. Hence, if the depletion allowance is to be availed of in the case of a field or territory in which new wells are being drilled, each individual well should be tested at the end of the year in order to determine the reduction thereof, or possibly each group of wells in operation at the beginning of the year and each group brought in during the year as separate units. New wells or new groups of wells brought in during the year may be tested as soon as they have reached the stage of settled production or regular flow and then again at the end of the year, the difference between the two tests determining the amount of reduction, if any.[8] Subsequently in the case of producing wells the tests for reduction must be approximately one year apart and, it seems, should preferably be at the beginning or end of the calendar or fiscal year of the owner.

Deductions by Lessees. Although a lessee is not permitted by the Treasury Department to claim a deduction for depletion he may claim three deductions with respect to the property: (a) for royalties paid during the year; (b) for an aliquot part of any "bonus" paid in addition to royalties, and (c) for depreciation.

ROYALTIES. In many states, under the terms of oil and gas leases, it is the custom to pay a rental to the

[8] T. D. 2447.

land owner, usual quarterly and usually at the rate of one dollar per acre, per annum, for the right to postpone or delay the drilling of oil on the land. When the well is drilled and oil is produced, the oil royalty is usually paid in kind, generally one-eighth of the oil produced and saved. In case gas is produced, the royalty is not paid in kind, but usually in cash at a certain sum per annum for each well. The delay rental is income to the owner, without any allowance for depletion, and is a proper item to be deducted as expense by the lessee. If, after production begins, the rental is paid in kind, that is, in oil or gas, the income of the owner is the amount he receives on the sale of his share, and the income of the lessee is the amount he receives on the sale of the share retained by him. From the amount the lessee receives in such cases no deduction can be made on account of the rental paid in kind. If the lessee retains the entire output of the well, and pays a rental or royalty in cash, he must report, as his income, the amount received on the sale of the entire output, but may deduct, as expense, the amount of the cash royalty paid to the owner.

"BONUS." The regulation of the Treasury Department provides that if a lessee, in order to secure the right to enter upon, explore, develop or operate gas or oil properties, paid or shall pay, a bonus in addition to royalties, the amount of such bonus so paid, may be ratably distributed over the life of the lease or over the productive life of the property, and the lessee may deduct annually, as a rental payment, an aliquot part of the amount of the bonus so paid, until such amount has been extinguished. The word "bonus" as here used means the amount paid by a lessee for the right to enter

upon, explore, develop, or operate gas or oil properties. In other words, it is the amount he may pay for the lease in addition to the annual royalties. One purchasing a lease from the previous lessee should consider the amount paid for such lease as a "bonus" to be deducted ratably each year. Thus, if A acquires a lease from the owner of the land, upon agreement to pay an annual royalty of one-eighth of the oil produced, he can neither claim an annual allowance for royalty nor a pro-rata allowance for "bonus," and his income from the property will be what he receives upon the sale of seven-eighths of the oil produced. If, however, A sells his leasehold to B for one million dollars, B may deduct as "bonus" a pro-rata part of one million dollars, as that sum is an amount paid by him to secure the right to enter upon, explore, develop, or operate the property. The pro-rata amount of "bonus" to be deducted annually is determined by dividing the amount of the "bonus" by the number of years constituting the life of the lease, or if the lease has partially expired when it is acquired, by the number of years it then has to run. If, however, the productive life of the property is estimated to be less than the life of the lease the amount of the "bonus" may be divided by the number of years estimated to be the productive life of the property, in order to determine the annual deduction. That is, the purpose is to permit the return to the lessee of the full amount of "bonus" in the shorter of the two periods of time.

Depreciation. Although the lessee is not entitled to any allowance for depletion of the natural resources, he may deduct as "depreciation" the incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc. Such expenses do not neces-

sarily enter into and form a part of the capital invested or property account and they may, at the option of the one operating the property, be charged either to property account or deducted from gross income as an operating expense. The practice among many operators seems to be to charge such expenses to property account until the field begins to produce, and thereafter to charge the cost of drilling additional wells in the same field to expense, that is, so long as the property is not producing income the expenditure is properly added to the property account, and depreciation claimed in subsequent years against the income of the property but after the property commences to produce the amount is properly charged against the current income from production. The cost of drilling dry or non-productive wells may be claimed as a loss. Depreciation may also be claimed on the cost of all physical property connected with the operation, such as rigs, tools, machinery of all kinds, pipes, casing, and other equipment, unless repairs and renewals are made each year to such an extent that no depreciation occurs and such repairs and renewals are charged to expense.

Statement to Be Attached to Annual Return. Where depletion is claimed under the above rules there should be attached to each return made by the individual or corporation owning and operating oil or gas properties, a statement showing; (a) the fair market value of the property (exclusive of machinery, equipment, etc.) as of March 1, 1913, if acquired prior to that date, or (b) the actual cost of the property, if acquired subsequent to that date; how the fair market value of the property as of March 1, 1913, was ascertained, the quantity of oil or gas produced during the year for which the return

was made; the quantity produced during the year immediately preceding; how the depletion deduction claimed in the return was computed, whether upon the decline in flow and production of individual wells, groups of wells, or the entire field; and any other data which will be helpful in determining the reasonableness of the depletion deduction claimed in the return.

Statement by Lessee. If the operator is a lessee, that fact should be stated and an explanation given as to the basis and property upon which any depreciation deduction is claimed, that is, depreciation due to use, wear and tear of physical property, the lessee not being entitled to any deduction for depletion or exhaustion of the oil or gas products, but being entitled to deduct annually as a rental payment, an aliquot part of any stipulated sum or bonus paid for the right to enter upon, explore, develop and operate oil or gas territory, as well as the royalty payments made to the lessor for the oil or gas removed from such property, provided the entire proceeds from the oil or gas produced during the year are returned in the gross income of the operator.[9]

Rule Under 1913 Law. The 1913 Law made no express provision for an allowance for depletion of oil and gas wells and the Treasury Department made no rulings outlining any method of claiming such depletion.

Rule Under 1909 Law. Under the 1909 Law, which was silent on the subject of depletion, the Treasury Department permitted allowances for depreciation of oil wells. Owners were required to adopt an average value per barrel of the settled daily production as the guide

[9] T. D. 2447.

in determining the value of the property at the time of the incidence of the tax or upon the date of commencement of production. With this basis per barrel the value of the property as a whole was to be determined by applying such unit value per barrel to the daily average production for the month of December, or other representative month in the year for which the return was made, the representative month chosen being the same in each year. The same unit value per barrel was to be retained in computing all future deductions for depreciation except where an additional production was secured by drilling, or acquired by purchase, in which case a new average rate per barrel based upon the actual cash invested might be adopted. The amount of the allowance each year was ascertained by multiplying the unit value by the difference between the daily average production in barrels during the representative month of each year. It was considered that by following this plan that the capital invested in the producing property would be automatically and wholly extinguished coincident with the complete exhaustion of the product, with the exception of such salvage as might remain after the exhaustion.[10] In the case of gas wells the Treasury Department permitted a deduction for depreciation on a basis either of reduction of rock pressure or of reduction of volume. The cost of drilling gas wells was permitted to be charged to investment or to expense and the general custom of natural gas companies in the distribution of the cost of drilling wells was recognized.[11]

10 T. D. 1755.
11 T. D. 1754.

CHAPTER 34

DEDUCTION OF ALLOWANCE FOR DEPLETION OF MINES

The 1916 Law provides that individuals and corporations may deduct a reasonable allowance for the depletion of mines, not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made.[1] The allowance is to be made under rules and regulations to be prescribed by the Secretary of the Treasury. The purpose of permitting the allowance is to enable the taxpayer having capital invested in the mining deposit to receive back the capital originally invested, or in the case of purchase made prior to March 1st, 1913, the fair market value of the deposit, or his interest therein, as of that date, and when the aggregate of allowances reaches such sum no further allowance is permitted. Under this provision of the law, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, has made regulations which are discussed in the following paragraphs.

Depreciation Not Included in Depletion. It should be borne in mind that depletion is an allowance for the wasting of the natural resources and does not include any allowance for loss due to exhaustion, wear and tear of physical property used in the discovery or removal

1 Act of September 8, 1916, § 5 (a) and § 12 (a).

of such natural resources. An allowance for depreciation should be claimed separately and apart from the allowance for depletion and should be determined according to the rules laid down with respect to depreciation.[2] Depletion is a deduction allowed for the purpose of returning the capital invested by a taxpayer in natural resources at or about the time the natural resource is exhausted. In addition to the deduction allowed to measure the loss due to depletion the taxpayer will also be allowed the usual depreciation of the machinery, equipment, etc., used in connection with the operation of removing the natural resource.[3]

Who May Claim Deduction. The owner of the mine content or of an interest therein is the one who may claim the allowance for depletion. Ownership at the time for which the computation is made is essentially prerequisite. Lessees or operators are not entitled to any allowance for depletion, if they have no capital invested in the deposit, but they may, of course, deduct the royalties or rentals paid from year to year to the owner. If, however, a lessee has paid a fixed sum to the owner for the right to explore, develop or operate a mine, the amount so paid is capital invested by him and may be ratably distributed, either over the life of the lease, or the probable life of the mine under ordinary operating conditions, whichever is the shorter, and he may deduct annually, an aliquot part of the amount so paid, until such amount has been extinguished.[4]

Basis of Deduction. The purpose of the deduction is to permit the return to the taxpayer, free from tax, of

2 T. D. 2446; see Chapter 32.
3 Reg. 33, Art. 143.
4 T. D. 2446.

either (a) the amount of capital invested in the mine (not including the amount invested in mining machinery, buildings or other physical property subject to depreciation) or (b) the fair market value of his interest in the mine itself (that is, the mineral deposit not including machinery, buildings, etc.) on March 1, 1913, if the property was acquired prior to that date. When the amount of capital invested, or value at the incidence of the tax, has been extinguished by a series of annual allowances, no further allowance will be permitted. For this purpose the taxpayer is required to keep an accurate ledger account showing the amount on the basis of which he claims depletion and the amount of depletion deductions allowed each year; when the account balances no further deductions should be made. The amount of invested capital once fixed is final, and a re-valuation will not be allowed during the period of the ownership under which it was determined, although it may later develop that the estimated quantity of the mineral deposit was understated at the time such amount was fixed. If the property changes hands, the new owner, of course, establishes a new basis, which will be the price he pays for the mineral deposit.[5]

Capital Invested. This phrase, as used in the preceding paragraph, means the actual cost to the owner[6] and, it seems, should include not only the original cost of the property (excluding physical appurtenances subject to wear and tear and consequently treated under the head of depreciation) but also the cost of development work to bring the property to an operating condition, such as, wages, fees, taxes and other necessary expenses.

[5] T. D. 2446.
[6] T. D. 2446.

Amounts expended after the property begins to produce income, should not be charged to capital if they are items which may be deducted from net income for the year, except to the extent that such expense of development exceeds the income.[7]

Fair Market Value as of March 1, 1913. If the taxpayer acquired mineral deposit, or interest therein, prior to March 1, 1913, the amount of capital invested, which may be extinguished through annual depletion deductions, is the fair market value of the deposit or interest therein as of March 1, 1913. This value must not be based upon the assumed salable value of the output under current operative conditions less cost of production, for the reason that the value under such conditions would comprehend the earning capacity of the property. Neither should the value be speculative, but must be determined upon the basis of the salable value *en bloc* as of that date, of the entire deposit of minerals contained in the property owned, exclusive of the improvement and development work; that is, the price at which the natural deposits or mineral property, as an entirety, in its then condition, could have been disposed of for cash or its equivalent. The precise detailed manner in which the estimated fair market value of mineral deposits as of March 1, 1913, shall be made, must naturally be determined by the taxpayer. It must be on such basis as will not comprehend any operating profits. The estimate in all cases is subject to the approval of the Commissioner of Internal Revenue, and once the value has

7 Ascertaining the cost for purpose of depletion should be governed by the same general rules as apply to ascertaining the cost of assets for the purpose of computing the profit on the sale thereof. See Chapter 20.

been fixed there can be no re-valuation if it should be found that the estimated quantity of the mineral deposit was understated at the time the value was fixed. If the value as of March 1, 1913, cannot be ascertained in any more definite way, the original cost of the mineral deposit may be taken, allowance being made for minerals which have been removed prior to that date.[8]

Rate of Annual Deductions. The amount of allowance for depletion, which may be deducted each year is required by the law to be reasonable, and is held by the Treasury Department to be such sums as will reasonably amount, in the aggregate, to the capital invested at or about the time the deposit is exhausted. The annual allowance is limited, however, to an amount not to exceed "the market value in the mine of the product thereof which has been mined and sold during the year."[9] To determine what is a reasonable amount and to fix the limit of the annual allowance, the Treasury Department has ruled that at the time of acquiring ownership, or as of March 1, 1913, as the case may be, an estimate must be made of the number of units (tons, pounds, etc.) in the deposit. The capital invested (or the value of the deposit on March 1, 1913) divided by this estimated number of units will determine the per unit value of the deposit in the mine, and this per unit value multiplied

8 T. D. 2446.

9 A question arises here as to whether the product mined in one year and sold in the next can be considered in fixing this limit. It does not seem likely that Congress in using the phrase "mined and sold" contemplated that both operations must take place in the same year, but rather that the limit should be determined by the product sold during the year, mined on the particular property for which allowance is claimed.

by the number of units mined, and sold during the year will fix the allowance for that year.[10]

ILLUSTRATION. As an illustration of the method of computing the annual deduction, suppose that the original investment, or the value as of March 1, 1913, is $50,000, and the estimated number of units is one million. The per value unit will be five cents, and, if one hundred thousand units are mined and sold during the year, the annual allowance for that year will be $5,000. Assume that the production and sale has been maintained at this rate for five years; one-half of the original cost will then have been returned to the owner. If at that time the mine is sold for $50,000, and it is then ascertained that 500,000 units still remain in place in the deposit, the new owner may set up $50,000 as the capital invested which, divided by 500,000 units will allow him a per unit value of ten cents, to be multiplied by the number of units mined and sold each year in ascertaining the annual deduction thereafter. The probable number of units in a deposit cannot always be estimated with any degree of accuracy. If the number is ascertained in good faith, and in the exercise of the taxpayer's best judgment, supported by such reports of engineers or mining experts as he may have, it would seem to be sufficient. The law requires the annual allowance to be "reasonable" and any reasonable method used in estimating the extent of the deposit should suffice. It does not seem to be contemplated that an expensive survey shall be undertaken in making the estimate. As the per unit value determines the rate at which depletion may be claimed, it follows that the estimate should be conservative, since a too liberal estimate of the extent

10 T. D. 2446.

of the deposit may find the owner unable to claim his full allowance before the property is exhausted.

Allowance on Each Separate Deposit. Where a taxpayer owns more than one mining property allowance may be computed for each separate mine or deposit, and the aggregate of such computations constitutes the allowance to which he is entitled.

Statement to Be Attached to Annual Return. Where depletion is claimed under the above rules there should be attached to the return of annual net income of the claimant a statement setting out whether the operator is a fee owner or a lessee; in the case of a fee owner, (a) the fair market value of the mineral deposits as of March 1, 1913, if the property was acquired prior to that date, (b) the cost of the mineral property if acquired subsequent to that date; the method by which the value as of March 1, 1913, was determined in case the property was acquired prior to that date; the estimated quantity in units in the mine as of March 1, 1913, or at the date of purchase, if acquired subsequent to that date; the number of units removed and sold during the year for which the return is made; and any other data which would be helpful in determining the reasonableness of the depletion deduction claimed in the return. In the case of a lessee, the statement should show (a) the amount of the bonus or other payment made for the right to operate the mine; (b) the period covered by the lease.[11]

Rule Under the 1913 Law. The 1913 Law provided for an arbitrary deduction in the case of an individual

[11] T. D. 2446.

or corporation for the depletion of mining deposits, not to exceed 5% of the gross value at the mine of the output for the year for which the computation was made.[12] Under this law it was held that taxpayers operating mines or oil or gas wells upon a royalty only, could not claim depreciation because of the exhaustion of the deposit.[13] It was also held that in order to claim a deduction for depletion the amount of such deduction had to be charged off on the books so as to constitute a liability against the assets of the taxpayer. A general ledger entry was required so that the amount charged off would be reflected in the annual balance sheet.[14] It was later held however, that failure to write off depletion would not result in disallowing the deduction.[15]

Rule Under the 1909 Law. Under the 1909 Law the Treasury Department allowed a deduction for depletion on the unit value basis,[16] although the law was silent. When a case involving the question came before the Supreme Court it was held that the fact that the revenues derived from operating mines resulted to some extent in exhaustion of the capital, established, under that law, no ground for deducting the value of the ore from the gross income as depreciation,[17] and, further, that Congress did not intend to cover the necessary depreciation of a mine, by exhaustion of the ores, in determining the income to be assessed under the statute,

12 Act of October 3, 1913 ¶ B and ¶ G (b).

13 Reg. 33, Art. 145.

14 Letter from Treasury Department dated May 18, 1916; I. T. S. 1917, ¶ 1428.

15 T. D. 2481.

16 T. D. 1675.

17 Stratton's Independence Ltd. v. Howbert, 231 U. S. 339, 34 Sup. Ct. 136; 58 L. Ed. 285.

by including such exhaustion within the allowance for depreciation.[18] In a later case, decided in a lower court, these decisions were held not to apply to a company mining ore by stripping off the surface covering the deposit, the court being of the opinion that where a company could strip the surface from a deposit and thus definitely and certainly ascertain the extent or character thereof, or ascertain it by means of test pits, shafts and drilling from the surface, the owner or lessee could ascertain with certainty the value of his property on January 1, 1909, and deduct that value from each ton in ascertaining the net income under the 1909 Law.[19]

18 Von Baumbach v. Sargent Land Co., 242 U. S. 503.
19 Biwabik Mining Co. v. U. S., 242 Fed. 9.

CHAPTER 35

RETURN OF ANNUAL NET INCOME

For the purpose of assessing the tax, a return of annual net income is required, showing the gross and net income for the taxable year. This chapter deals with the general provisions relating to returns of annual net income, and does not cover the annual or special returns required with respect to withholding at the source, information at the source or other matters. For a discussion of such returns attention is directed to the chapters on the respective subjects.

By Whom Filed. The law requires the return of annual net income to be filed by each person of lawful age having a net income of $1,000 or over for the calendar year, if the individual is unmarried, and $2,000 or over if the individual is married.[1] Guardians, trustees, executors, administrators, receivers and other fiduciaries are required to make a return if the income of beneficiaries is $1,000 or $2,000 as indicated above, and as to undistributed income, it seems that a return is re-

[1] Act of September 8, 1916, § 8 (b), provides for the filing of returns by persons of lawful age having a net income of $3,000 or over for the taxable year but this provision is superseded by the Act of October 3, 1917, § 3, which requires a return to be filed under conditions indicated in the context. The 1917 Law will govern the filing of returns until it is repealed or amended. As to non-resident aliens, see Chapter 5.

quired when such income is $1,000 or over for the taxable year.[2] Minors and incompetents are not required to file returns but their fiduciaries are required to file returns for them. A return is required from every corporation subject to the tax regardless of whether or not it has been in receipt of any income during the taxable year.[3] The term "taxable year" as here used means the calendar year, except in cases where a corporation has designated its fiscal year as such.

HUSBAND AND WIFE. If a husband and wife, living together, have separate estates, the income from both may be reported in one return, but the amount of income of each, and the full name and address of both, must be shown in such return. Ordinarily, the husband, as the head and legal representative of the household, and general custodian of its income, should make and render the return of the aggregate income of himself and his wife. If, however, the wife does not disclose her income to the husband, each may make a return, in which case the personal exemption may be divided between the two in such proportions as they agree upon. If either husband or wife separately has an income equal to or in excess of $2,000 a return is required under the law. If the aggregate income of both is $2,000 or more, the Treasury De-

[2] Act of September 8, 1916, § 8 (c), as amended by Act of October 3, 1917, requires no return of net income not exceeding $3,000, but this provision is superseded by § 3, Act of October 3, 1917. The law is obscure as to returns of undistributed net income of trust estates, but as the specific exemption under the 1917 Law is only $1,000, a return will no doubt be required if such income exceeds that amount.

[3] Act of September 8, 1916, § 13 (a).

partment requires a return, although neither may have an income of $2,000.[4]

AGENTS. When a return is made by any person acting as agent for the taxpayer, the agent assumes the responsibility of making the return and incurs the penalties provided for erroneous, false or fraudulent returns.[5] When the required return has not been made by such agent notice of failure to make the return will be served upon him, and in answer thereto he will be permitted to file evidence with the collector showing that the individual for whom he acts did not receive an income subject to tax during the year, or that the agent filed the return with some other collector.[6] One who acts as agent does not, however, assume any fiduciary relationship within the meaning of the income tax law and, unless otherwise provided, the principal and not the agent is subject to the liability under the law.[7]

Where Filed. The law permits the filing of the return by an individual in the district in which such individual has his legal residence or principal place of business, or, if he has no legal residence or place of business in the United States, then with the Collector of Internal Revenue at Baltimore, Maryland.[8] Although

[4] This statement is based upon the ruling contained in Regulations 33, Art. 10, which held under the 1913 Law that if either husband or wife had an income of $3,000 a return should be filed although the aggregate incomes of both might not be $4,000 and if the aggregate income of both was over $4,000 a return should be filed although the individual income of either one might not amount to $3,000.

[5] Act of September 8, 1916, § 8 (b).

[6] Reg. 33, Art. 18.

[7] T. D. 2137.

[8] Act of September 8, 1916, § 8 (a).

the law permits the return to be filed in either one of the two districts indicated above, the Treasury Department desires for administrative purposes that the return be filed in the district in which the individual resides.[9] Corporations are required to file their returns with the collector of the district in which is located the principal office of the corporation, where are kept its books of account and other data from which the return is prepared, or, in the case of foreign corporations, with the collector of the district in which is located the principal place of business in the United States, or if they have no principal place of business, office, or agency in the United States, with the Collector of Internal Revenue at Baltimore, Maryland.[10]

When Filed. March 1st is the primary due date for all returns of annual net income. This due date can be changed by a corporation designating a fiscal year, in which case the sixtieth day after the close of the fiscal year becomes the primary due date on or before which

9 Letter from Treasury Department dated December 17, 1914. The Treasury Department recognizes that the individual has the right to choose one of two districts, where he resides in one and does business in another, and a filing in either district will be a proper compliance with the law. For the year 1913 the Treasury Department requested the filing of returns in the district in which the individual's principal place of business was located. This threw an undue burden on the collectors in the large cities, and the subsequent ruling was made in order to remedy this condition.

10 Act of September 8, 1916, § 13 (b). As stated in the chapter on corporations the principal office here referred to is the business office, not the statutory office in the state in which the corporation is incorporated. The return may be filed from the latter office only when a domestic corporation has no other office or place of business in this country.

its return should be filed. Unless an extension of time is obtained, the taxpayer will be held delinquent if his return is not filed on or before the primary date and will be subject to the 50% additional tax and penalty of the law.[11]

LAST DUE DATE. These words are used to designate the last day upon which a return may be filed without penalty.[12] When the due date for a return falls on a Sunday or a legal holiday, the last due date will be held to be the day next following, and the return may be filed not later than such following day without penalty.[13]

MAILING RETURNS. If a return is made and placed in the United States mails, properly addressed, and postage paid, in ample time, in the due course of the mails, to reach the office of the collector or deputy collector, on or before the last due date, no penalty is held to attach should the return not be actually received until a subsequent date.[14]

Extension of Time by Collectors. Collectors, being satisfied as to the merits of the claim, and in the reasonable exercise of their judgment and discretion, have authority to grant an extension of time not to exceed thirty days in the case of "sickness or absence."[15] In the case of corporations, the sickness or absence must

[11] T. D. 2001.

[12] Reg. 33, Art. 175.

[13] Reg. 33, Art. 176.

[14] Reg. 33, Art. 174.

[15] R. S. § 3176; Reg. 33, Art. 17; T. D. 1950.

be of an officer whose signature to the return is required.[16]

Extension of Time by Commissioner. In addition to the limited extension of thirty days, which may be granted by collectors, the Commissioner of Internal Revenue has authority to grant a reasonable extension of time in meritorious cases for filing returns of income by persons, residing or traveling abroad, who are unable to file the returns on or before March 1st.[17] The Commissioner of Internal Revenue also has authority in the case of either corporations or individuals to grant a reasonable extension of time in meritorious cases, as he may deem proper, for any reason whatever.[18]

Application for Extension of Time. A written application for an extension of time should be made by the individual to the collector or the Commissioner within the period for which the extension is desired.[19] The application need not be made prior to the primary due date, but may be made at any time within the period for which extension is desired, not to exceed thirty days after the primary due date when application is made to collectors.[20]

TENTATIVE RETURNS. Prior to the passage of the 1916 Law, extension of time could be granted only in case of sickness or absence, but the Treasury Department permitted foreign corporations, and domestic corporations doing business in foreign countries, who were un-

16 Reg. 33, Art. 173.
17 Act of September 8, 1916, § 8 (b).
18 Act of September 8, 1916, § 14 (c).
19 Reg. 33, Art. 23.
20 Reg. 33, Art. 173.

able to assemble their data in time to make their returns of annual net income on or before the primary due date, to file tentative returns approximating as nearly as possible the actual business transacted during the year. Such tentative returns, were accepted subject to the substitution later of true and correct returns, when the necessary data to make the same had been received.[21] Under the 1916 Law, the Commissioner of Internal Revenue has authority to grant unlimited extension in meritorious cases, thus making unnecessary the filing of tentative returns.[22]

Forms. The law authorizes the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, to prescribe the form on which the returns shall be made. The forms have been changed from time to time, and those for 1917 will contain much new matter. The same form is prescribed for citizens, residents, and non-resident aliens, whether or not executed by the principal or by an agent on his behalf. Separate forms are prepared for use by fiduciaries, and corporations. The form for use by individuals is known as Form 1040. The form for use by fiduciaries is known as Form 1041. The forms for use by corporations are: Form 1030 for insurance companies (including mutual life and mutual marine;) Form 1030a for mutual insurance companies (other than mutual life and mutual marine;) Form 1090 for railroad corporations, and Form 1031 for all other corporations. Forms are usually sent to taxpayers, but failure to receive a form is no excuse for not making the return.[23]

[21] T. D. 2137.
[22] See T. D. 2561 and T. D. 2581.
[23] Reg. 33, Art. 163.

Verification of Returns. The annual return must be verified by the oath of the person making the same. The affidavit may be made before the collector of the district or before any officer authorized by law to administer oaths.[24] Revenue agents, inspectors and special employees,[25] or any clerk in the office of the collector,[26] may, if commissioned as deputy collectors, take the oath of taxpayers. If a return is executed before a notary in a state where the law does not require the notary to use a seal, and none is used, a certificate of a clerk of court or other officer possessing a seal, showing that he is duly commissioned and authorized to administer oaths, should be filed with the Commissioner; otherwise the return will not be accepted,[27] unless, as may be done, the collector waives this requirement in states where jurats are accepted in the state courts either with or without a seal, and without certificate showing authority.[28]

VERIFICATION ABROAD. An individual residing abroad may acknowledge his return before any duly appointed officer of the country in which he resides, authorized to administer oaths and use an official seal.[29]

VERIFICATION IN ARMY AND NAVY. Any officer in the Naval or Military service of the United States, within or without the United States, who is authorized to administer oaths for the purpose of Military justice and

24 Reg. 33, Art. 22.
25 T. D. 2235, T. D. 2238.
26 T. D. 2293.
27 T. D. 2090.
28 T. D. 2174.
29 T. D. 2090.

administration or Naval justice and administration, may take the acknowledgments of persons in the Naval and Military services.[29a]

Assistance of Collectors. Any assistance or information, which may be needed in connection with the preparing and filing of income tax returns, is required to be furnished by the collector upon request. Questions regarding the tax will be answered upon inquiry at the Internal Revenue offices. When questions are directed to the Treasury Department at Washington asking for information which should be supplied by collectors, the letters are referred to the collectors for reply and the writers are advised accordingly.[30]

Return Made by Collector. If the taxpayer fails to file a return as required by law, but consents to disclose the particulars of his income, it is the duty of the collector or deputy collector to make the return, which, being distinctly read and consented to, signed, and verified by the taxpayer, may be received as the return of the taxpayer.[31] If the taxpayer neglects or refuses to make the return, or makes a wilfully false or fraudulent return, it is the duty of the collector, after due notice, to make the return according to the best information he can obtain by the examination of such person, or any other evidence. When duly certified by the collector, such return is treated as the return of the taxpayer and the tax and penalty are assessed thereon.[32]

29a T. D. 2534.
30 T. D. 1949, T. D. 1956.
31 Reg. 33, Art. 20.
32 Reg. 33, Art. 21.

Erroneous Returns. If a return is improperly prepared, it is returned by the collector to the taxpayer for correction, and the corrected return is accepted without penalty, provided the incorrect return showing the date of its receipt accompanies the corrected return.[33]

Amended Returns. Where upon an audit of a return of an individual, a fiduciary, or a withholding agent, or as a result of an investigation made by a revenue agent, an additional tax is assessed, it is not necessary to file an amended return. Notice of the additional assessment will be given to the taxpayer by letter from the Treasury Department.[34] Where a corporation is called upon by a revenue inspector to make amended returns, the officers of the corporation will be given the fullest opportunity to make any investigation they may desire prior to signing such amended returns, provided, of course, such investigation does not cover an unreasonable length of time.[35] In 1915 and 1916 it was the practice of the Treasury Department to send out a letter to corporations whenever items on the return were reached, concerning which more detailed information was sought, referring to the return and briefly requesting information regarding one or more items therein. The letter ended with a statement that in the absence of an explanatory affidavit, at the end of thirty days from the date of the letter, the entire amount of the

[33] Mimeograph letter No. 1160 to Collectors.

[34] Mimeograph letter No. 1232 to Collectors.

[35] Letter from Treasury Department dated February 2, 1915; I. T. S. 1917, ¶ 1618.

deductions questioned would be suspended and an assessment returned accordingly.[36]

Notice of Failure to File Returns. When the collector possesses any information which leads him to believe that any person in his district was in receipt of income for the year and did not make a return, he is required to serve a notice calling attention to the failure and to the fact that penalties for failure have been incurred. The notice also calls attention to the fact that if the return is not filed, within ten days from the date thereof, the books and papers of the taxpayer will be examined and a return prepared therefrom as provided by law.[37]

Inspection of Returns by the Public. The income tax law is specific and mandatory in the matter of safeguarding from publicity the information acquired by reason of its requirements relative to annual returns of income. The law imposes on employees of the Government a penalty of fine, imprisonment, dismissal from office and forfeiture of right to hold office, for making known in any manner not provided by the law, the amount or source of income, or any particulars thereof, set forth or disclosed in an income return by any person. All internal revenue officers are cautioned to preserve as confidential all income tax returns.[38] The returns

36 I. T. S. 1917, ¶ 1623.

37 Reg. 33, Art. 196. This notice is sent out on Form 1045. For the first year of the income tax, March 1 to December 31, 1913, the collector sent out an informal letter as a preliminary to the formal notice. This letter invited the taxpayer to make a return without penalty within ten days but the letter was not used in subsequent years.

38 T. D. 2135, T. D. 1962.

on which assessments have been made are filed in the office of the Commissioner of Internal Revenue and constitute public records and are open to inspection as such, but only upon order of the President and under rules and regulations prescribed by the Secretary of the Treasury and approved by the President.[39] It was held that a similar provision of the 1909 Law permitting the inspection of returns was not unconstitutional.[40] Under date of July 28, 1914, the President issued an executive order, that returns should be subject to inspection in accordance with certain rules and regulations prescribed by the Secretary of the Treasury of the same date.

RETURNS MUST BE INSPECTED AT WASHINGTON. Returns can be inspected by the public only in the office of the Commissioner of Internal Revenue in Washington. No collector or any other internal revenue officer outside of the Treasury Department in Washington is authorized to permit the inspection of any return, or to furnish any information whatsoever relative to any return or any information secured by him in his official capacity relating to such return. No provision is made in the law for furnishing a copy of any return to any person or corporation and no copy will be furnished to any other than the person or corporation making the return, or their duly constituted attorney, except in the case where copies are furnished to officers of the Department of Justice for use in suits.[41]

RETURNS OF INDIVIDUALS. Returns of individuals are not open to the inspection of any person other than the

39 Act of September 8, 1916, § 14 (b).
40 Flint v. Stone Tracy Co., 220 U. S. 107.
41 T. D. 2016.

proper officers and employees of the Treasury Department, the person who made the return or his duly authorized attorney, and are under no conditions made public, except where such publicity results through the use of such returns in any legal proceeding in which the United States is a party.[42]

Returns of Corporations. The Secretary of the Treasury, at his discretion, upon application to him, setting forth what constitutes a proper showing of cause, may permit the inspection of the return of any corporation by any *bona fide* stockholder thereof. Application for such inspection must be made in writing to the Secretary of the Treasury, setting forth the reasons why inspection should be permitted. Attached to the application should be a certificate signed by the president or other principal accounting officer of such corporation, countersigned by the secretary, under the corporate seal of the company, that the applicant is a *bona fide* stockholder in the company. Where such certificate cannot be secured, other evidence will be considered to determine the fact whether or not the applicant is a *bona fide* stockholder. Upon receipt of such application the corporation, whose return it is desired to inspect, is notified of the facts and given opportunity to state whether any legitimate reason exists for refusing permission. The privilege of inspecting the return of any corporation is personal to the stockholders, and the permission granted by the Secretary of the Treasury to make such inspection cannot be delegated to any other person.[43] A person who, as trustee or in any other fiduciary relation, has the ownership or possessory right to stock in

[42] T. D. 2016.
[43] T. D. 2016.

a corporation, is considered as a stockholder in such corporation.[44] Copies of returns on file in the Commissioner's office are not permitted to be sent to any person, except the corporation itself, or its duly authorized attorney, and in no case may the original returns be removed except upon order and by direction of the Secretary of the Treasury or the President.[45]

Corporations Which Offer Their Stock to the Public for Sale. The returns of all corporations, whose stock is advertised in the press or offered for sale to the public by the corporation itself, may be inspected by any person upon written application to the Secretary of the Treasury, which application shall set forth briefly and succinctly all facts necessary to enable the Secretary to act upon the request. In case of doubt as to whether any company falls within this classification, the person desiring to see such return should support his application by advertisements, prospectus or such other evidence as he may deem proper to establish the fact that the stock of the corporation is offered for general public sale.[46]

Corporations Whose Stock Is Listed on a Stock Exchange. The returns of all companies whose stock is listed upon any duly organized and recognized stock exchange within the United States, for the purpose of having its shares dealt in by the public generally, are open to the inspection of any person upon written application to the Secretary of the Treasury, which application shall set forth briefly and succinctly all facts

[44] Op. Atty. Gen. Dec. 27, 1910.
[45] Reg. 33, Arts. 178 and 179.
[46] T. D. 2016.

necessary to enable the Secretary to act upon the request.[47]

Inspection of Returns by State Officers. The proper officers of any state, imposing a general income tax, may on request of the Governor thereof have access to the returns of corporations, or to the abstracts of such returns showing the name and income of each corporation, at such times and in such manner as the Secretary of the Treasury may prescribe. A request for such inspection must be signed by the Governor of the state and sealed with the seal of the state and transmitted to the Secretary of the Treasury for his consideration and action thereon.[48]

Inspection of Returns by Government Officers. Returns of corporations (but not of individuals) may be inspected by an officer or employee of any department of the Government, on application to the Secretary of the Treasury by the head of the executive department in which such officer or employee is employed. If the return of a corporation is desired to be used in any legal proceedings other than those to which the United States is a party, or to be used in a manner by which any information contained in the return could be made public, the application for permission to inspect the return, or to furnish a certified copy, must be referred

[47] T. D. 2016.

[48] T. D. 2016. It is to be noted that the law permits inspection only by officers of states which have a general income tax. This may not necessarily mean a tax on both corporations and individuals, but the privilege to inspect returns applies only to the returns of corporations.

to the Attorney General for his recommendation before transmission to the Secretary of the Treasury.[49]

For Use in Government Suits. All returns whether of persons or of corporations may be furnished, upon approval of the Secretary of the Treasury, for use in any legal proceedings before any United States grand jury or in the trial of any cause to which both the United States and the person or corporation rendering the return are parties, provided the return would constitute material evidence in the prosecution, defense or trial of such action or proceeding. In any case arising in the collection of the income tax the Commissioner of Internal Revenue may furnish for the use of the proper officer either the original or certified copies of returns, without the approval of the Secretary of the Treasury.[50]

49 T. D. 2016.
50 T. D. 2016; Reg. 33, Art. 180.

CHAPTER 36

ASSESSMENT AND PAYMENT OF THE TAX

All assessments are made by the Commissioner of Internal Revenue.[1] After the return of annual net income has been filed with the collector, it is sent to the Treasury Department at Washington for assessment of the tax. When the assessment has been made, the amount thereof is reported to the local collector who notifies the taxpayer, on or before June 1st, of the amount thereof. The tax becomes due on the 15th day of June, but an additional period of grace, being at least ten days after June 15, is allowed before penalty or interest applies. In the case of corporations reporting for their fiscal years the return of net income, when filed, is immediately forwarded to the Treasury Department at Washington and the tax assessed thereon. The amount thereof is reported to the local collector who notifies the corporation and payment is due 105 days from the date on which the return of income is required to be made in such cases, and after ten days notice and demand by the collector.[2] If the tax is not paid within ten days after notice and demand by the collector, which notice cannot be given before the 15th day of June or before the expiration of 165 days after the close of the fiscal year of a corporation reporting on the basis of its fiscal year,

1 Act of September 8, 1916, § 9 (a) and § 14 (a).

2 Act of September 8, 1916, § 14 (a).

penalty and interest accrue. The Government may proceed by levying on and distraining the property of the taxpayer if payment of penalty and interest is not made within ten days from the date of the second notice and demand for the tax. This drastic means of enforcing payment is within the power of Congress since the power to tax includes the power to undertake effectual means to collect the tax.[3]

Suit to Restrain Assessment or Collection. No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.[4] The constitutionality of a law cannot be inquired into in an injunction suit against the government,[5] but may be in a stockholder's suit to enjoin the corporation from *voluntarily* paying a tax charged to be unconstitutional.[6] An injunction will not be granted at the instance of a stockholder to restrain the officers of a corporation from paying the tax, other than voluntarily, as that would, in effect, be the same as an action to restrain the Government.[7] Allegations that an assessment is irregular and void do not constitute any ground for an injunction.[8] A bill in equity will not lie to enjoin collection although the

3 McCulloch v. Maryland, 4 Wheat. 316; Flint v. Stone-Tracy Co., 220 U. S. 107.

4 R. S., § 3224.

5 Delaware R. R. Co. v. Prettyman, 17 Int. Rev. Rec. 99; Allen v. Pullman's Palace Car Co., 139 U. S. 658; Dodge v. Brady, 240 U. S. 122.

6 Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; Flint v. Stone-Tracy Co., 220 U. S. 107; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

7 Strauss v. Abrast Realty Co., 200 Fed. 327.

8 Alkan v. Bean, 23 Int. Rev. Rec. 351.

tax is alleged in the bill to have been illegally assessed.[9] A collector cannot be restrained from collecting an assessment by injunction.[10] It is contrary to every principle of equity jurisprudence that the collection of taxes on personal property should be stayed by injunction.[11] The courts will not interfere by a mandamus with the executive officers of the Government in the exercise of their ordinary official duties.[12] In matters which require an executive officer to exercise judgment or discretion no rule will issue for mandamus.[13] The inhibition of Section 3224 applies to all assessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing the income tax. The remedy of a suit to recover back the tax after it is paid is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it. The system of administrative measures, not judicial, to collect internal revenue taxes, with appeals to specified tribunals, and suits to recover back moneys illegally exacted is a system of corrective justice intended to be complete, and enacted under the right belonging to the Government to prescribe the conditions on which it would

9 Snyder v. Marks, 109 U. S. 189; Dodge v. Osborn, 240 U. S. 118.

10 State R. R. Tax cases, 92 U. S. 575; Keely v. Sanders, 99 U. S. 441.

11 Nye v. Washburn, 125 Fed. 818.

12 U. S. v. Black, 128 U. S. 40. The court in this case followed an earlier decision of Decatur v. Paulding (14 Pet. 497) and made clear the distinction between the mere ministerial act of the executive officer, which may be controlled by the courts by mandamus, and an act in the performance of which an officer is vested with quasi-judicial discretion.

13 Carrick v. Lamar, 116 U. S. 423.

subject itself to the judgment of the courts in the collection of its revenues.[14]

Notice of Assessment. When the assessment has been made by the Commissioner of Internal Revenue the collector is notified and he sends the taxpayer a notice of assessment, usually on or before June 1.[15] This notice, however, is not a demand for payment of the tax, but is merely a notification of the amount which has been assessed and the date on which the tax is due and payable. Failure to pay the tax on receipt of this notice does not make the taxpayer liable for penalty or interest. In the case of a corporation making returns for a fiscal year, the notice of assessment is given on or before the expiration of ninety days from the day when the return was required to be filed.[16]

Notice and Demand for Tax. If the tax is not paid on or before the date on which it is due, a notice and demand is issued to the taxpayer. The notice and demand is usually dated and sent out on the day the tax is due. It calls attention to the fact that the tax has been assessed, showing the amount thereof, and demands payment on or before a date given in the notice. Unless

[14] Dodge v. Osborn, 240 U. S. 118.

[15] The notice is given to corporations on a form known as Form 1-647A and to individuals on Form 1-647B. The two forms are essentially the same. Each is divided into three parts, one part for the taxpayer (which will operate as his receipt when he pays the tax), one part for the record of the Commissioner, and one part for the record of the local collector. When the tax is paid all three parts of the notice should be presented to the local collector who will properly receipt the part intended for the taxpayer and retain the other two parts.

[16] Reg. 33, Art. 177.

the tax is paid within the time specified the penalty imposed for delay in payment of the tax will be added to the assessment.[17] This notice and demand is necessary in order to make the taxpayer liable for the penalty and interest in case of delay in payment of the tax, and is necessary to complete the government's lien on property belonging to the taxpayer. The fact that a claim for abatement is pending, or the tax is in litigation, does not relieve the collector from issuing the notice.[18] The notice may lawfully be given by mail and when so given is presumed to have been received. The burden rests on the taxpayer to prove the contrary in order to avoid the penalty.[19] The practice of the Department in such cases is to permit the taxpayer to show, to the satisfaction of the Commissioner, that he did not receive the notice, and upon such showing to give the taxpayer an opportunity to pay his taxes without penalty. The record of the collector showing that notice had been duly mailed is considered merely as prima facie evidence that the notice was received.[20] The date appearing on the notice and demand, as the last date on which the tax may be paid without penalty, should be a date ten days subsequent to the actual mailing of the notice and not necessarily ten days from the date of the notice. The date of mailing controls.[21]

17 Reg. 33. Art. 197. Form 1-17A is used in notifying corporations and Form 1-17B in notifying individuals. The forms are essentially the same, each is divided in three parts in the manner and for the purpose described in the preceding note regarding the notice of assessment.

18 T. D. 1995.

19 U. S. v. General Inspection and Loading Company, 204 Fed. 657.

20 I. T. S. 1917, ¶ 2268.

21 T. D. 1659.

NOTICE AND DEMAND TO ABSENTEES. When an individual is absent in a foreign country and it is impossible for him to receive the notice and demand in time to make payment of the taxes assessed thereon within the ten-day period following the service of the notice, the collector will make an allowance so that the tax may be paid without penalty ten days after receipt of the notice, and, if the full amount of the tax has been placed in the mail for transmission within ten days after such receipt, the penalty and interest will not be exacted. In such a case the envelope which enclosed the notice, bearing the postmark of the receiving office, should, if possible, be forwarded to the collector as evidence of the cause of delay. This ruling applies only to the collection of the tax from individuals,[22] but it would seem to be a reasonable rule to apply to all cases where the time consumed in the transmission of the mails makes it impossible to mail the notice and demand and to receive reply in ten days.

Second Notice and Demand for Tax. If the tax is not paid within ten days after mailing the first notice and demand, a second notice and demand is given the taxpayer, which states that having failed to make payment of the tax within the prescribed time after notice and demand, there has attached a 5% penalty on the tax and interest at 1% per month from a specified date. In this notice, demand is made for the taxes, penalty and such interest as may accrue before payment, together with a threat that if the tax, penalty and interest is not paid within ten days from the date of the notice, the Collector of Internal Revenue will collect the same with costs by seizure and sale of property.[23]

[22] T. D. 2028.

[23] Form 1-21A is used in giving corporations the second notice and demand for tax and Form 1-21B is used in notifying in-

Time of Payment of Tax. The primary due date is June 15th, or in the case of corporations reporting for their fiscal years the 165th day after the close of their fiscal years. In the case of corporations care should be taken to reckon the days correctly, as 165 days is not equivalent to five and one-half months. The second due date is the date given on the notice and demand for tax, which date should be not less than ten days after the first due date. The second due date is the last day on which the tax may be paid without penalty or interest. The payment of the tax may be made at any time during the last day. To accommodate those who make payments after closing time a mail box is provided at the cashier's window in the office of the local collector for the deposit of such collections.[24]

ADVANCE PAYMENT OF TAX. The Secretary of the Treasury, under rules and regulations prescribed by him, is required to permit taxpayers liable to income taxes to make payments in advance in instalments, or in whole, of an amount not in excess of the estimated taxes which will be due from them, and upon determination of the taxes actually due any amount paid in excess shall be refunded as taxes erroneously collected. When payment is made in instalments, the law requires at least one-fourth of such estimated tax to be paid before the expiration of thirty days after the close of the taxable year, at least an additional one-fourth within two months after the close of the taxable year, at least an additional one-fourth within four months after the close of the tax-

dividuals. The forms are essentially the same, each is divided into three parts in the manner and for the purpose described in the note regarding the notice of assessment.

24 T. D. 1728.

able year, and the remainder of the tax due, on or before the regular due dates fixed by law. The Secretary of the Treasury may allow a credit against taxes so paid in advance of an amount not exceeding the rate of 3% per annum, calculated upon the amounts so paid from the date of such payment to the regular due date fixed by law; but no such credit is allowed on payments in excess of taxes determined to be due, nor on payments made after the expiration of four and one-half months after the close of the taxable year.[25] All the penalties provided by law for failure to pay the tax when due, are applicable to any failure to pay the tax at the time or times above stated, in case the taxpayer chooses to pay in advance. The purpose of applying the penalties to such advance payments seems to be to protect the taxpayer, who chooses to make payments in advance, from the legal disability of recovering voluntary payments of taxes. By applying the penalties the taxpayer may, if he observes the rules as to protest and duress, pay the tax in advance and thereafter sue to recover if he has overpaid or paid under an erroneous assessment.

Manner of Payment of Taxes. As a general rule, payment of the tax is authorized by law to be made in certified checks drawn in favor of the collector on national and state banks and trust companies located in the city where the collector has his office, and also such "out-of-town" certified checks as can be cashed without cost to the government, providing the depositary will accept for deposit "out-of-town" certified checks "without recourse." Prior to this year the Treasury Department did not specifically authorize the acceptance of any form of exchange in payment of internal revenue taxes,

[25] Act of October 3, 1917 (Public No. 50), § 1009.

other than currency and such certified checks as are above described.[26] There was no objection to a collector accepting at his own risk, or at the risk of the government depositary, uncertified checks, or any other form of exchange, for collection only.[27] Where a form of remittance not authorized by law was accepted for collection, the 5% penalty was incurred by the taxpayer, if there was delay in collection and the funds were not actually received by the collector within the time provided by law. Receipt by the Government depositary, in the course of collection, was held not to be receipt by the collector, as the depositary is not an agent of the collector or of the government.[28] At present the law provides that, under rules and regulations prescribed by the Secretary of the Treasury, collectors may receive, at par and accrued interest, certificates of indebtedness issued under Section 6 of the Act entitled "An Act to authorize an issue of bonds to meet expenditures for the National security and defense, and, for the purpose of assisting in the prosecution of the war, to extend credit to foreign governments, and for other purposes," approved April 24, 1917, and any subsequent act or acts. Under the same provision of law, and under rules and regulations prescribed by the Secretary of the Treasury, collectors may also receive uncertified checks in payment of income taxes, during such time, and under such regulations, as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe; but if a check so received is not paid by the bank on which it is drawn, the person by whom such check has been tendered shall remain liable for the pay-

[26] T. D. 1990.
[27] T. D. 2158.
[28] T. D. 1651.

ment of the tax and for all legal penalties and additions the same as if such check had not been tendered.[29] If payment is made by check the taxpayer as a precaution should draw the check for such amount as to cover any collection charges by the bank, in order that the net amount received by the Government may be the full amount of tax due.

Payment Under Protest. The purpose of paying a tax under protest is to preserve the taxpayer's rights to recover the tax should the assessment prove to be wrongful or excessive. As a general rule of law, a voluntary payment of money cannot be recovered and this rule applies to payments of taxes. It does not seem essential, although it may be a wise precaution, also to protest at the time of filing the return on which the assessment is based.

RECOVERY OF TAXES FROM COMMISSIONER OF INTERNAL REVENUE. It would seem that a protest is not necessary to recover taxes from the Commissioner of Internal Revenue, but essential if suit is to be maintained against an *adverse decision* of the Commissioner.[30] It is a principle universally recognized that an action cannot be maintained for the recovery of money paid in discharge of a tax illegally assessed, unless the payment was made under protest. But this principle has been held by the Commissioner of Internal Revenue and other officers of the Department as too technical and too exacting for application to the refund of taxes under Section 3220 of the Revised Statutes.[31]

[29] Act of October 3, 1917 (Public No. 50), § 1010.

[30] Chesebrough v. U. S., 192 U. S. 253.

[31] Real Estate Savings Bank v. U. S., 16 Court of Claims 335; 27 Int. Rev. Rec. 154.

RECOVERY BY ACTION AT LAW. Though there is some conflict in the dicta of the Supreme Court, the true doctrine seems to be that when taxes are paid under protest or with notice that the payer contends that they are illegal and intends to institute a suit to compel their repayment, a sufficient foundation for suit to recover has been established.[32] It appears that a collector is not personally liable for taxes if no protest or objection is made to their collection by him.[33]

FORM OF PROTEST. There seems to be no legal requirement that a protest be in writing. An oral protest may be effective,[34] but a written protest is, of course, better evidence. A protest against paying the tax includes the penalties without specific mention of the latter. Where a corporation had been assessed for taxes and the same were not paid, a writ of distraint was issued by the collector, and, the corporation having been notified that the tax would be collected by levy, the deputy collector counted out and took from a representative of the company a sufficient amount to pay the tax against verbal protest at the time. A written notice of protest was then served in which the corporation denied that it was liable to the tax. The court held that the protest was sufficient.[35] Under the 1909 Law the Treasury Department ruled that no form of protest was prescribed, any form of protest would be sufficient if filed before payment of the tax, and the right of protest was not to be denied.[36]

32 Herold v. Kahn, 159 Fed. 608.

33 Commissioners, etc. v. Buckner, 48 Fed. 533.

34 Wright v. Blackeslee, 101 U. S. 174.

35 Abrast Realty Co. v. Maxwell, 206 Fed. 333.

36 T. D. 1675.

PROTEST ALONE NOT SUFFICIENT. The protest is used to give effect to other attending circumstances. A protest accompanying a voluntary payment is not sufficient. There must be coercion and duress. The protest gives notice that the payment is not to be considered as admitting the right to make the demand, but if payment of the tax is made under protest, without any coercion by actual or threatened exercise of power by the party exacting or receiving the payment, over the person or property of the party making the payment, from which the latter has no other means of immediate relief than such payment, the payment is voluntary and cannot be recovered.[37] "Where a party pays an illegal demand, with full knowledge of all the facts which render such demand illegal, without an immediate and urgent necessity therefor, or unless to release his person or property from detention, or to prevent an immediate seizure of his person or property, such payment must be deemed voluntary."[38] The duress and coercion must come from the Government or its agents,[39] not from a third party and the protest must be made to a duly authorized agent of the Government having authority to collect the tax.[40]

Duress. To recover the tax, payment must be made under duress and accompanied by a protest. As indicated in the preceding paragraph the duress must come from the Government and be such as to create an immediate and urgent necessity for paying the tax, in order to protect the person or property of the taxpayer. The cases contain a wide discussion of what constitutes duress

37 Chesebrough v. U. S., 192 U. S. 253.

38 Railroad Co. v. Commissioners, 98 U. S. 541; Little v. Bowers, 134 U. S. 547.

39 Chesebrough v. U. S., 192 U. S. 253.

40 U. S. v. New York & Cuba Mail S. S. Co., 200 U. S. 488.

under various circumstances and particular statutes. A discussion of the general question would not be of particular value in this work. Clearly a payment made upon receipt of the notice of assessment would not be a payment under duress, since that notice does not demand the tax and does not contain any threat of penalties. It seems reasonably certain that payment after receipt of the notice and demand for tax would be payment under duress, although the present form of such notice,[41] does not contain a specific threat to collect the penalties but merely a statement that the penalties will accrue if the payment is not made on or before a certain date. The form of notice and demand in use prior to 1917 contained a direct threat that the collector would collect the tax with penalty and interest if payment was not made within the ten day limit. In a case where a notice very similar in form and containing such a threat had been served on a taxpayer under the War Revenue Act of June 13, 1898, the court said in part: "Every demand by one clothed with official legal authority to make the demand, imposes a certain compulsion on the one upon whom the demand is made. Such a demand is always exigent and places the recusant in a position of disadvantage. Especially is this so in regard to payment of taxes, state or national. The proper administration of the fiscal affairs of the Government, require that the payment of taxes should not be delayed by disputes as to their legality, but that the taxes should first be paid and all questions in regard to them be determined in suits brought for their refunding. It is a wise policy, therefore, that encourages the payment under protest of disputed taxes. Though there is some conflict in the

41 Form 1-17. Compare this notice with Form 17 in use prior to 1916.

dicta of the Supreme Court, we think that the true determination is that, when taxes are paid under protest that they are being illegally exacted, or with notice that the payor contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such a suit has been established. In the case at bar, however, there was more than the simple payment of the tax under protest as to its illegality, as it was paid upon the demand of the Collector, coupled with a threat that unless promptly paid, the same would be collected with a penalty and interest at 1% per month. Payment upon such a demand from a government official, acting within the scope of his authority, constituted such a duress as clearly made such payment involuntary."[42] It seems that the present form of notice and demand although not containing an express threat to collect the 5% penalty and interest, but containing a statement that such penalty and interest will accrue, is sufficient duress to compel involuntary payment by the taxpayer in order to protect himself from the penalty and interest. However, there can be no doubt that payment upon receiving the second notice and demand is clearly payment under duress, since that notice threatens the seizure and sale of the taxpayer's property to satisfy the tax, penalty, interest and costs.[43] If the taxpayer delays payment until the receipt of such notice, in order that it may be shown that payment was clearly made under duress, penalty and interest must also be paid, and the protest should be not only against payment

42 Herold v. Kahn, 159 Fed. 608; 86 C. C. A. 598; citing Chesebrough v. U. S., 192 U. S. 253; 24 Sup. Ct. 262, 42 L. Ed. 432, and City of Philadelphia v. Collector, 5 Wall. 720, 18 L. Ed. 614.

43 See Form 1-21A or 1-21B.

of the tax but against payment of such penalty and interest as well.

Form of Receipt for Payment of Tax. The only official receipt for taxes that collectors may sign under the law is the form prescribed by the Department. However, there is not objection, on the part of the Department, to collectors signing commercial receipts or voucher checks, but they should in signing such receipts or vouchers write or stamp across the face thereof "not an official receipt." The official receipt must also be furnished, and an unofficial receipt is not in any manner binding on the Government and will not be received by it as evidence of payment of the tax.[44] Deputy collectors may give taxpayers, at the time of the payment, a personal receipt stating that the amount of payment has been received to be forwarded to the collector.[45]

Abatement and Refund. The taxpayer may file a claim for abatement of an assessment which he thinks is erroneous after the assessment has been made and before the tax is paid, or may file a claim for refund of a tax which he thinks has been erroneously assessed after the tax is paid. A further discussion of this subject is contained in the chapter on abatement and refund.[46]

Additional Assessment. The law provides that in cases of refusal or neglect to make a return and in cases of erroneous, false, or fraudulent returns, the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after the return

[44] T. D. 2226.
[45] T. D. 2341.
[46] See Chapter 39.

is due, or has been made, make a return upon information obtained as provided for in the law, or require the necessary corrections to be made, and in such cases the assessment made by the Commissioner of Internal Revenue thereon shall be paid by the taxpayer immediately upon notification of the amount of such assessment. The usual ten day period of grace, however, applies to such assessments as well as to the regular assessments.[47] Although the Commissioner of Internal Revenue has power summarily to assess the tax upon discovery of income which has not been reported, yet if such discovery is made prior to the day on which the tax is due (June 15th or in the case of the corporations filing for their fiscal year 165 days after the closing of the fiscal year) the tax cannot be summarily assessed, but may be paid at any time before the regular due date with an additional period of ten days of grace.[48] Where a summary assessment is made after the regular due date, the tax is due immediately upon notice and demand given by the collector.[49] Additional assessment may be made where the erroneous return is due to an honest mistake, and where the mistake is not discovered until after the tax is assessed and has been paid in the regular course.[50]

AMENDED RETURNS. Where an individual or a fiduciary or a withholding agent has been found subject to a further tax as a result of the audit of his return, or an investigation made by a revenue agent, it is not necessary to file an amended return, but the taxpayer is advised

47 Act of September 8, 1916, § 9 (a) and § 14 (a).

48 T. D. 2003.

49 Reg. 33, Arts. 177 and 184.

50 Eliot National Bank v. Gill, 218 Fed. 600; 134 C. C. A. 358.

by letter of the amount of additional tax to be assessed and the reasons for making such assessments.[51] In the case of corporations amended returns are required, but the examining officers of the Government are required to give the officers of the corporation the fullest opportunity to make any investigation that may be desired prior to signing the amended returns, provided such investigation does not cover an unreasonable length of time.[52]

THREE-YEAR LIMITATION ON SUMMARY ASSESSMENT. The statute authorizes the Commissioner of Internal Revenue to make a summary assessment of the tax on undisclosed income, if the discovery is made within three years after the return in which such income should have been reported was due. It is not necessary that the assessment be made within three years, so long as the discovery is made within that time. In computing the three year period, March 1, the date on which the returns should have been filed or was filed in due course, should be excluded. The general rule in the interpretation of statutes, where time is to be computed from a particular day, is to exclude the day thus designated and to include the last day of the specified period.[53] The three years limitation in this provision is not a limitation upon the right of the Government to sue for unpaid taxes, but at most is a limitation upon the right of the collecting officers to make assessment and enforce the payment by the summary statutory proceedings.[54]

51 Mimeograph letter No. 1232 to Collectors.

52 Letter from Treasury Department dated February 2, 1915; I. T. S. 1917, ¶ 1617.

53 Eliot National Bank v. Gill, 218 Fed. 600; 134 C. C. A. 358; National Bank of Commerce v. Allen, 223 Fed. 472; 139 C. C. A. 20.

54 U. S. v. Grand Rapids & Indiana Ry. Co., 239 Fed. 153.

WAIVING THE THREE-YEAR LIMITATION. While the Government is fully authorized to recover taxes by suit upon discovery of liability to original or additional tax after the three-year period, the Treasury Department prefers that the collection should be made in the ordinary statutory method, that is, as a result of a formal assessment. In order that this may be done taxpayers are requested to make amended returns and to execute waivers in such form as will waive the three-year statutory limitation. In executing such waiver, the taxpayers forfeit none of their rights and assume no liability to any penalty that might not be enforced against them in the absence of such waiver. If the taxpayer, against whom an additional tax liability is discovered, will formally accept the findings of the examining officer and agree voluntarily to pay the tax, this amounts to a waiver and neither amended returns nor waivers will be required.[55] There seems to be no objection to a taxpayer signing a waiver where additional tax liability is discovered after the expiration of the three-year period, providing he does not question the legality of the assessment. The result of signing a waiver will be to compel him to pay the tax under protest and sue for its recovery, while if a waiver is not signed, the Government becomes the plaintiff in an action brought to collect such tax.

REFUND OF TAXES COLLECTED ON SECOND ASSESSMENT. Where a second assessment is made in case of a list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or which contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected

55 Mim. Letter No. 1192 to Collectors.

under such assessment be refunded or paid back, unless it is proved that said list, statement, or return was not false or fraudulent, and did not contain any understatement or undervaluation.[56]

Interest on Delinquent Taxes. Interest for the full time from the second due date will be collected on an assessment the abatement for which has been applied for and rejected; that is time consumed in considering the claim must be included.[57] Where penalty has been added for delinquency, interest is reckoned upon the entire assessment including both the tax and the penalty.[58] Interest is recoverable as interest and not as penalty.[59]

Suit for Collection of Taxes. Where net income has been incorrectly stated in a return and the tax based upon such return has been paid, an action of *indebitatus assumpsit* will lie to recover the balance of the tax, which should have been levied and paid, without any formal assessment of such tax. Neither the limitation of three years as to summary assessment, nor any other statute of limitation bars an action by the United States Government to recover the difference between the amount of the tax levied and paid and the amount which should have been levied and paid, if the return had correctly stated the net income.[60] In the collection of the taxes imposed by statute the Government is not confined to the summary proceedings therein provided, but may resort to a plenary suit. Where a tax of a fixed percentage

56 R. S., § 3220.

57 Reg. No. 1, page 110.

58 T. D. 870, February 27, 1905.

59 U. S. v. Guest, 143 Fed. 456.

60 U. S. v. Minneapolis Threshing Machine Co., 229 Fed. 1019.

is imposed by the statute on a subject or object which is so definitely described in the statute that its amount or value, on which the fixed percentum is to be calculated, can be ascertained and determined, on evidence, by a court, a suit for the tax will lie without an assessment.[61] Suits for the collection of taxes can be brought at any time whether the taxes have been assessed or not, or whether they are or are not assessable.[62] Interest on taxes sued for runs from the time the taxes were due.[63]

Lien for Unpaid Taxes. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment-list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person.[64]

NOTICE OF LIEN. The Government's lien for collection of taxes is not valid as against any mortgagee, purchaser or judgment-creditor, until notice of such lien has been filed by the collector in the office of the Clerk of the District Court of the District within which the property subject to such lien is situated, and is not valid in a state which by appropriate legislation authorizes the filing of such notice in the office of the registrar or recorder of deeds of the counties of that state, unless the notice is filed in the office of such registrar or

61 U. S. v. Grand Rapids & Indiana Ry. Co., 239 Fed. 153 and cases cited therein.

62 Dollar Savings Bank v. U. S., 19 Wall. 227; Kane v. U. S., 99 U. S. 229; U. S. v. Little Miami Co. et al., 1 Fed. 700.

63 U. S. v. Erie R. R., 106 U. S. 327.

64 R. S., § 3186.

recorder of deeds of the county (or parish in the State of Louisiana) within which the property subject to the lien is situated.[65] A lien for taxes is not similar to the lien of an ordinary incumbrance. It is not displaced by a sale under a pre-existing judgment or decree, unless otherwise directed by statute. It attaches to the *res* without regard to individual ownership, and when it is enforced by sale pursuant to the statute prescribing the mode of assessing and collecting taxes, the purchaser takes a valid and unimpeachable title.[66] To create a lien, demand must be made for a specific amount; all steps required by law must be pursued strictly. The lien requires an assessment, a notice of the tax due, and a specific demand upon the individual taxpayer for payment.[67] The Government is not compelled to resort to a sale of chattels and personal effects of a taxpayer, before instituting proceedings to enforce a lien on the taxpayer's real estate and leaseholds, and such lien may be enforced against the grantees of the taxpayer's real estate and leasehold interests subsequent to the filing of the list with the collector and demand upon the taxpayer, although the grantees had no notice of the lien.[68]

TIME WHEN LIEN ATTACHES. The statute expressly provides that a lien for unpaid taxes in favor of the United States shall attach from the time when the assessment-list was received by the collector, except when

65 See Act of March 4, 1913, amending § 3186 R. S. Prior to the Act of March 4, 1913, it was not necessary to file any notice in compliance with State laws to make a lien effective. (U. S. v. Snyder, 149 U. S. 210).

66 Osterberg v. Union Trust Co., 93 U. S. 424.

67 U. S. v. Pacific R. R., 1 Fed. 97.

68 U. S. v. Curry, 201 Fed. 371.

otherwise provided. No other provision seems to be applicable to the income tax law. The 1916 Law provides in part that "all administrative, special and general provisions of law, including the laws in relation to assessment, remission, collection and refund of internal-revenue taxes not heretofore specifically repealed and not inconsistent with the provisions of this title, are hereby extended and made applicable to all the provisions of this title and to the tax herein imposed."[69] Under the Income Tax Law it is the duty of the Commissioner of Internal Revenue to send to each collector a list of the taxpayers liable for the tax in his district, showing the amounts for which they are liable, within such time that the collector may give the required notice of assessment on or before the first day of June, and upon such lists the collections are made. The lien is fixed upon the assets of the taxpayer when this list comes into the collector's hands. In the case of a corporation which has distributed its assets prior to the time when a lien would attach thereto, the Government may proceed to collect the tax as a general creditor.[70]

Taxes Collectible by Distraint. If any person liable to pay any taxes neglects or refuses to pay the same within ten days after notice and demand, it shall be lawful for the collector or his deputy collector to collect the taxes, with the 5% penalty, and interest at the rate of 1% per month, by distraint and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, of the person delinquent.[71] This section of the statute exempts certain property from

69 Act of September 8, 1916, § 22.
70 See Chapter 12 on corporations.
71 R. S., § 3187.

distraint in the case of the head of a family. Extensive provision is made in the statute for the mode of levying distraint and proceedings on distraint.[72]

[72] See R. S., §§ 3188, et seq.

CHAPTER 37

PENALTIES AND COMPROMISES

Several penalties are contained in the law for failure to comply with its provisions and for making false or fraudulent statements in the returns. The penalties take two forms: (a) specific penalties in the nature of fines between minimum and maximum limits, and (b) penalties of either 50% or 100% of the amount of tax due.

Suit to Enjoin Collection of Penalties. While Section 3224 of the Revised Statutes, which prohibits suits to enjoin the collection of internal revenue taxes, does not specifically include "penalties" as such, yet where penalties are authorized by the statute to be added to the tax and collected as a part of the tax, the courts will hold that the penalty is a part of the tax, and its collection cannot be enjoined.[1]

Failure to File Return of Annual Net Income. If an individual fails to file a return the specific penalty is not less than $20 nor more than $1,000.[2] In the case of a corporation the specific penalty is any amount not exceeding $10,000.[3] In any case of failure to file a

1 Kohlhamer v. Smietanka, 239 Fed. 408.

2 Act of September 8, 1916, § 18.

3 Id. § 14 (c).

return or list within the time prescribed by law or by the collector, the Commissioner of Internal Revenue also adds to the tax 50% of its amount.[4]

EXCEPTION. When a return is voluntarily, and without notice from the collector, filed after the time prescribed by law, and it is shown that the failure to file was due to a reasonable cause and not to wilful neglect, the addition of 50% of the tax is not made.[5] The notice referred to in this provision of the law is the formal notice contemplated by Section 3173 of the Revised Statutes.[6] Where revenue agents or examining officers receive a return after the due date, or examine the books covering a delinquent return for the year 1916, or any subsequent year, the assessment of 50% additional will be recommended only if such formal notice had been given prior to the filing of the return, or the discovery of unreported income. If the formal notice has not been given prior to such discovery or to the making of the return, a return will be considered voluntarily filed, although informal notice may have been given by the collector or agent.[7] This provision waiving the penalty in case of voluntary filing is contained in a section of the general revenue laws amended by and contained in the 1916 Law and has been held, by the Treasury Department, to apply only to returns filed under the 1916 Law, since Section 24 of the 1916 Law continues in force all the provisions of the 1913 Law for the assessment and collection of taxes which have accrued thereunder, and for the imposition

[4] R. S. § 3176; T. D. 1950.

[5] R. S. § 3176, as amended by Act of September 8, 1916.

[6] This notice is known as Form 1045.

[7] Mimeograph letter to Collectors, C. T. No. 54.

and collection of all penalties and forfeitures. In the case of delinquent returns filed under the 1909 and the 1913 Laws, the respective provisions of those laws will be enforced and the additional tax assessed, together with the specific penalty. The 50% additional tax will be assessed, or reported for assessment, only in those cases under the 1913 and 1909 Laws where the delinquency was discovered within three years from the date the returns were due to be filed, and the specific penalty will be assessed only in those cases in which the delinquency was discovered within five years from the date the returns were due.[8] The ruling of the Treasury Department holding that the provision which waives the penalty applies only to returns filed under the 1916 Law, does not seem to take into consideration the fact that although the provision is contained in the 1916 Law, yet it is an amendment to a section of the revenue laws applying generally and, it seems, operates to supersede the penalty provisions of the 1913 Law and the 1909 Law with respect to all returns filed under those laws on and after September 9, 1916, as well as to returns under the 1916 Law.

Returns of Withholding Agents. Failure to make and file withholding returns on or before March 1st renders a withholding agent liable to the specific penalty or not less than $20 nor more than $1,000, but the 50% addition to the tax for failure to make a return, and the 100% addition for intentional false or fraudulent return, is not assessed against withholding agents.[9]

[8] Mimeograph letter to Collectors, C. T. No. 56.
[9] Mimeograph letter to Collectors, No. 1265.

Specific Penalty Not Waived by Accepting Return. The specific penalty is not waived or remitted by the fact that the Commissioner accepts a delinquent return.[10]

Intentional Neglect or Refusal to Make Returns. The same specific penalties apply to intentional neglect or refusal to make returns as apply to all cases of failure to make returns, but in the case of intentional neglect or refusal the penalty of 100% of the tax is added, unless the neglect is due to sickness or absence.[11]

False Returns. The law provides that "in case a false or fraudulent return or list is wilfully made, the Commissioner of Internal Revenue shall add to the tax 100 per centum of its amount. This provision does not seem to include returns which are false in the sense of containing mistakes or unintentional misstatements. A return may be false, in the sense used in those sections of the law which permit summary assessments in the case of erroneous, false or fraudulent returns, without being false in the sense used in the provision prescribing the penalty tax of 100%.[12] There seems to be no penalty imposed in case a return is false in the sense of being incorrect in the absence of wilful intent to make a false return.

Fraudulent Returns. Where a false or fraudulent return is wilfully made the Commissioner of Internal Revenue adds to the tax 100% of its amount. This

10 U. S. v. Suprise 5, 10 & 19c Store, not yet officially reported.

11 T. D. 1950.

12 Act of September 8, 1916, § 9 (a) and § 14 (a). Eliot Nat. Bank v. Gill, 218 Fed. 600.

increase is only made in case the return is fraudulently false.[13]

Fine Against Officer of Corporation. In case an officer of a corporation, charged with the duty and responsibility of making and verifying a return, makes a false or fraudulent return, with the intent of defeating or evading any assessment or tax, he is guilty of a misdemeanor and subject to a fine not to exceed $2,000, or to imprisonment not to exceed one year, or both, at the discretion of the court, together with the costs of prosecution.[14]

Failure to File Information at Source. Any person, corporation, partnership, association or insurance company called upon to supply information required by the law, who refuses or neglects to do so at the time or times specified in each year, shall be liable to a penalty of not less than $20 nor more than $1,000.[15]

FAILURE TO WITHHOLD TAX AT THE SOURCE. Any person required by law to deduct and withhold the tax at the source is personally liable for such tax.[16]

Delay in Payment of the Tax. In the case of individuals any sum or sums due and unpaid after the 15th day of June in any year, and for ten days after notice and demand thereof by the collector, there shall be added the sum of 5% on the amount of tax unpaid,

13 National Bank of Commerce v. Allen, 223 Fed. 472.

14 T. D. 1950, Act of September 8, 1916, § 18.

15 Act of September 8, 1916, § 18, as amended by Act of October 3, 1917.

16 Act of September 8, 1916, § 9 (b).

and interest at the rate of 1% per month upon said tax from the time the same became due. In the case of corporations, the same penalty, and the same rate of interest, is added to any sum or sums due and unpaid after the 15th day of June in any year (or after 105 days from the date on which the return of income is required to be made in the case of corporations reporting for their fiscal years) and for ten days after notice and demand thereof by the collector.[17] This penalty and interest do not accrue in case of any tax due from the estates of insane, deceased or insolvent persons, where the return was made by the incapacitated person and he becomes insane, or dies, or becomes insolvent, after making the return and prior to the required date of payment of the tax.[18] When an assessment has been made for a tax or penalty and within ten days after demand a claim for abatement is filed, and accepted by the collector, the time ceases to run against the claimant as to the 5% penalty, until the claim is rejected. Upon receipt of the notice of rejection of the claim, the tax may be paid within ten days from the date of the notice, without penalty. Interest at the rate of 1% per month, however, continues to run and is collected for the full number of calendar months which intervene between the date of the expiration of the first ten days' notice and the date of payment of the tax, notwithstanding that a claim for abatement has been filed.[19]

17 Act of September 8, 1916, § 9 (a) and § 14 (a).

18 Letter from Treasury Department dated April 1, 1916; I T. S. 1917, ¶ 476.

19 Reg. No. 14, October 15, 1911; Reg. No. 1, page 110.

Statute of Limitations. The Revised Statutes [20] provide that no suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. The statute does not run, however, if the person liable for the penalty is not to be found within the United States so that proper process may be served against him.

Compromise of Penalties. The Commissioner of Internal Revenue, with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon; and, with the advice and consent of the said Secretary, and the recommendation of the Attorney General, he may compromise any case after a suit thereon has been commenced. Whenever a compromise is made in any case there shall be placed on file in the office of the Commissioner the opinion of the Solicitor or Internal Revenue, or of the officer acting as such, with his reasons therefor, with a statement of the amount of tax assessed, the amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and the amount actually paid in accordance with the terms of the compromise.[21] He has under this section no power to compromise a suit against the Government,[22] the power

20 R. S., § 1047.

21 R. S., § 3229; see § 3469, as to compromise of cases after judgment.

22 23 Op. Atty. Gen. 507.

being limited to suits which the Government may prosecute. A compromise operates for the protection of the offender against subsequent proceedings as fully as a formal conviction or acquittal, and is a bar to further action.[23] Where an action is brought by the United States against a delinquent taxpayer, for having failed to file a return, the verdict must specifically state the amount of the penalty, after which the only remedy of the defendant (other than an appeal) is to apply for a compromise.[24] Offers in compromise should include payments of cost.[25] The amount of the offer should be deposited with the Commissioner, but cannot be held or set off against the tax due.[26]

Specific Penalties. While the sections of the Revised Statutes relating to compromises[27] do not in express language refer to the compromise of the specific penalty for failure to file the return, neither are they restricted in terms, nor by any reason of public policy, to penalties for the non-payment of taxes. In the opinion of the Attorney General the application of these sections to compromise of penalties for failure to file returns in time is proper, and, further, that in such compromises the Commissioner is authorized to consider not only the pecuniary interests of the Treasury, but also general considerations of justice, equity and public policy.[28]

23 U. S. v. Chouteau, 102 U. S. 603.

24 U. S. v. Acorn Roofing Co., 204 Fed. 157.

25 T. D. 642, March 20, 1903.

26 Boughton v. U. S., 12 Ct. Cls. 330.

27 R. S., §§ 3229 and 3469.

28 29 Op. Atty. Gen. 217.

FIFTY PER CENT. INCREASE OF TAX. The penalty of 50% increase in tax for failure to file returns is found in practically all revenue laws relating to special taxes, and the uniform construction has been that no administrative officer is clothed with authority to compromise such increase in tax.[29] The income tax law is explicit and mandatory in its provisions relative to the additional assessment of 50% of the tax otherwise due, in case of failure to file a return of income within the prescribed time, and does not give discretionary authority for remission of these additional taxes to any officer of the Government.[30] Since the 50% penalty was not subject to compromise under the general revenue laws, Congress passed an act providing particularly for the refund of such additional taxes, assessed under the 1909 Law, for neglect to file returns, [31] but no such statute has been passed with respect to penalties incurred under the 1913 Law or the 1916 Law.

Offers in Compromise. It is the practice of the Treasury Department to accept, as a minimum offer, $5 from individuals and withholding agents, and $10 from corporations, in compromise of the specific penalty incurred for failure to file returns, in cases where the neglect was not intentional.[32] Offers in compromise do not receive favorable consideration in cases where returns for the year in question have not been filed, but such offers are accepted "subject to the filing of the return."[33] No particular form is prescribed for

29 T. D. 1701.
30 T. D. 2135.
31 Act of March 3, 1913.
32 T. D. 2311; T. D. 2349.
33 T. D. 2311.

use in making offers in compromise of the specific penalties, and such offer may be made in the form of a letter addressed to the local collector. Each offer in compromise should be accompanied by an affidavit in which the proponent should state briefly the facts which caused the delinquency. Where affidavits allege facts that no delinquency was incurred or recite circumstances which warrant relief from the specific penalty, the offer is returned, unless there are facts in the possession of the collector at variance with the contentions made by the proponents. All delinquents who do not compromise their liabilities to the specific penalty, after ample opportunity, are reported to the United States District Attorney for proceedings.[34] It is the duty of every District Attorney to prosecute every case for the collection of a fine, penalty or forfeiture reported to him by any collector, unless, upon inquiry and examination, he decides that such proceedings cannot properly be sustained, or that the needs of public justice do not require that such proceedings be instituted; in which case he reports the facts to the Commissioner of Internal Revenue for his direction.[35]

[34] T. D. 2311.
[35] R. S., § 838.

CHAPTER 38

EXAMINATION OF TAXPAYERS' BOOKS

For the purpose of verifying returns the Commissioner of Internal Revenue may, by any duly authorized revenue agent or deputy collector, cause the books of a taxpayer to be examined, and if such examination discloses that the taxpayer is liable to tax in addition to that previously assessed, the same is assessed and becomes payable within ten days from the time of sending the taxpayer a notice and demand. For the purpose of such examination the books of the taxpayer shall be opened to the examining officer, or shall be produced upon a summons issued by any properly authorized officer.[1] The authority for making such examination of the taxpayer's books is contained in Sections 3172, 3173 and 3176 of the Revised Statutes, as amended by, and contained in, the 1916 Law. Under these general provisions applying to all revenue taxes, a collector may send out his deputies to make inquiries. If any person refuses to allow any regularly authorized Government officer to examine his books or the books of the person, firm, or corporation for whom he is agent, it is lawful for the collector to summon such person, or any other person having possession, custody or care of the books of account containing entries relating to the business of such taxpayer, or any other person

1 Reg. 33, Art. 186.

he may deem proper, to appear before him and produce the books at a time and place named in the summons, to give testimony or answer interrogatories under oath, respecting any objects or income liable to tax, or the returns thereof. The collector may summon any person residing or found within the state or territory in which his district lies; and when the person intended to be summoned does not reside and cannot be found within such state or territory, he may enter any collection district where such person may be found and there make the examination authorized by the law. If the taxpayer fails to make a return or makes, wilfully or otherwise, a false or fraudulent return, the collector or deputy collector is authorized to make the return from his own knowledge and from such information as he can obtain through testimony or otherwise.[2] Section 3173 of the Revised Statutes clothes collectors of internal revenue with supervisory powers over and authorizes them to investigate all accounts, lists, or returns made or required to be made to them by any and all classes of persons liable to pay taxes upon any property, trade or business.[3] It has also been held that the examination of books under this section is not an infringement of the Constitution.[4] In all suits and proceedings, other than criminal, arising under any of the revenue laws of the United States, the attorney representing the Government may, whenever in his belief any business-book, invoice, or paper, belonging to or under the control of the defendant or claimant, will tend to prove any allegation made by the United States,

[2] R. S., §§ 3173 and 3176, as amended by Act of September 8, 1916.

[3] U. S. v. Hodson, 14 Int. Rev. Rec. 100.

[4] In re Strouse, 1 Sawyer 605.

make a written motion particularly describing such book, invoice, or paper, and setting forth the allegation which he expects to prove; and thereupon the court may, at its discretion, issue a notice to the defendant or claimant to produce the same. Upon failure to do so the allegation stated in the motion is taken as confessed, unless the failure or refusal is explained to the satisfaction of the court.[5] This provision applies to proceedings under the Internal Revenue laws as well as the customs revenue laws.[6]

Instructions to Revenue Agents. The following instructions have been given by the Treasury Department to revenue agents and examiners: "In conducting their examination the agents will, except in clear cases of misrepresentation, proceed on the assumption that all errors in the returns rendered are unintentional; and they will, so far as possible, make their examination in such manner as not to interfere with the company's business, either as to the use of its books or in the general conduct of its affairs. Contentions with officers, employees or representatives of corporations are to be carefully avoided, and no action that may cause friction, that is not necessary in the proper performance of their duties, must be indulged in by officers making these examinations. Ordinarily no very extended examination of the company's books will be necessary, as the verification of the particular items to which attention has been called will be sufficient. Where, however, a thorough examination is found to be necessary, and the accounts are so kept as to involve much labor in their examination, the agent may assign two assistants

5 Act of June 22, 1874, 18 Stat. 187.

6 U. S. v. Distillery, 21 Int. Rev. Rec. 366.

for this purpose. Where discrepancies between the company's books and the return made are discovered, the officers of the company should be given full opportunity to explain the same, and to furnish, if so desired, a sworn statement in reference thereto. In such cases the agent will, if deemed necessary, require the attendance of any officer or employee of the company, and there examine such officer or employee respecting the matter under investigation. The witnesses in such cases should be duly sworn by the agent, and in case of refusal of any such officer or employee to testify, or in the case of refusal to produce the books or papers called for, the agent will at once report the fact to this office."[7]

[7] T. D. 1617.

CHAPTER 39

ABATEMENT, REFUND AND RECOVERY OF TAXES

The prompt collection of the revenue and its faithful application is one of the most vital duties of Government. Depending, as the Government does, upon its revenue to meet not only its current expenses, but to pay the interest on its debt, it is of the utmost importance that it should be collected with despatch, and that the officers of the Treasury should be able to make a reliable estimate of means in order to meet liabilities. It would be difficult to do this, if the receipts paid into the Treasury were liable to be taken out of it, on suits for alleged errors and mistakes, concerning which the officers charged with the collection and disbursement of the revenue had received no information. To guard against such consequences, Congress has from time to time passed laws on the subject of the revenue, which not only provide for the manner of its collection, but also point out a way in which errors can be corrected. These laws constitute a system which Congress has provided for the benefit of those persons who complain of illegal assessments of taxes and illegal exactions of duties. The party aggrieved can test the question of the illegality of an assessment or collection of taxes by suit; but he cannot do this until he has taken an appeal to the Commissioner of Internal Revenue. Thus it will be seen that the person who believes he has suffered wrong at the hands of the collector can appeal

to the courts; but he cannot do this until he has taken an intermediate appeal to the Commissioner, and, in any event, he is barred from bringing a suit, unless he does it within the period limited by law. The object of these different provisions is apparent. While the Government is desirous to secure to the citizen a mode of redress against erroneous assessments or collections, it says to him: "We want all controverted questions concerning the revenue settled speedily, and if you have complaint to make, you must let the Commissioner of Internal Revenue know the grounds of it; but if he decides against you, or fails to decide at all, you can test the question in the courts if you bring your suit within a limited period of time."[1] The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized, on appeal made to him, to remit, refund, and pay back all taxes erroneously or illegally assessed, or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected.[2]

Taxes Paid on Second Assessment. Where a second assessment has been made by the collector[3] in case of a list statement or return which, in the opinion of the collector, or deputy collector, was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid

1 Nichols v. United States, 7 Wall. 122; U. S. v. Real Estate Savings Bank, 104 U. S. 728.

2 R. S., § 3220.

3 See Chapter 36.

back, unless it is proved that said list and statement, or return, was not false or fraudulent, and did not contain any understatement or undervaluation.[4]

Who May Claim Recovery of Tax. As a general rule, the taxpayer against whom the tax is assessed and by whom the tax is paid is the one who is entitled to claim abatement or refund or sue for its recovery. In cases where the tax has been withheld at the source the claim for abatement or refund may be made either by the withholding agent against whom the assessment was made or by the person for whose account such taxes were withheld.[5] Where one corporation had leased all of its property to another, a tax being thereafter assessed upon the lessor, and its claim for an abatement being rejected, the tax was paid by the lessee to avoid the penalty threatened by the collector and to avoid distraint and sale of the leased property. The court held that the payment by the lessee was not voluntary and that it was entitled to sue for its recovery without regard to privity of contract between it and the collector.[6]

Abatement. The Secretary of the Treasury has provided two forms for the purpose of refund and abatement. One is made applicable to the return of taxes and penalties illegally or improperly assessed and paid, and the other for an abatement of their assessment. The former is applicable to cases where the taxes and penalties have been paid, and the latter to cases where they have not been paid. These regulations

4 R. S., § 3220.
5 Reg. 33, Art. 33.
6 Cambria Steel Co. v. McCoach, 225 Fed. 278.

of the Secretary have the force of law, and the Federal Courts are obliged to take notice of them. Furthermore, they are obviously binding upon the Commissioner and he obtains jurisdiction to pass upon a claim only when and as they have been complied with. The merits of a case come before him when a proper claim has been made. Under a claim for abatement he can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction.[7] The Commissioner possesses no equity powers in case of abatement; if the tax is a legal one he cannot abate it.[8] It seems that the Commissioner has no authority to revoke the abatement of a tax once made by him, but he may re-assess the tax.[9]

EFFECT OF REJECTION OF CLAIM FOR ABATEMENT. By weight of authority it seems that, if an appeal is taken from an assessment and decided against the appellant, and the tax is afterwards collected, it is not necessary to take a second appeal for refund of the payment before commencing suit to recover the tax.[10] When the abatement claim has been considered and rejected upon its merits, no claim for refund is necessary to lay foundation for a suit.[11] In a recent case it was said: "What the Commissioner of Internal Revenue thought about the assessment had been obtained upon

7 Hastings v. Herold, 184 Fed. 759.

8 Decision No. 180, 36 Int. Rev. Rec. 13.

9 U. S. v. Alexander et al., 110 U. S. 325.

10 San Francisco Savings Society v. Cary, 2 Sawyer 393.

11 DeBary v. Dunne, 162 Fed. 961; Schwarzschild and Sulsberger Co. v. Rucker, 143 Fed. 656; T. D. 974; Grier v. Tucker, 150 Fed. 657; T. D. 1293; Contra, Hastings v. Herold, 184 Fed. 759.

full statement of the facts, and it would have been a useless form again, after the tax was paid, to appeal to the Commissioner and obtain the same judgment. The reason for the appeal did not exist, and hence the appeal after the tax was paid was not necessary."[12] This seems to be the general rule, but it has also been held to the contrary that under a claim for abatement the Commissioner can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction, and where the abatement was rejected, but no application was made for refund after paying the tax, it was held that a suit could not be maintained.[13]

PROCEDURE FOR CLAIMING ABATEMENT. Claim for abatement of taxes or penalties erroneously or illegally assessed, or which are abatable under remedial acts, etc., must be made out on the form prescribed by the Government[14] and must be sustained by the affidavits of the parties against whom the taxes were assessed, or of other parties cognizant of the facts.[15] The practice is to obtain the official form from the local collector, prepare it according to instructions and file it with the local collector. The claim for abatement can only be made between the time the tax is assessed and the date it is due. If the claim has not been acted upon within ten days after notice and demand for the tax, interest will accrue from the due date, but the 5%

12 Weaver v. Ewers, 195 Fed. 247.

13 Hastings v. Herold, 184 Fed. 759. The weight of authority seems to be contrary to the rule in this case.

14 The form prescribed by the Government is known as Form 47.

15 Reg. No. 14, Rev. October 15, 1911.

penalty for failure to pay the tax will not accrue if the tax is paid within ten days after the claim for abatement is rejected.[16]

Refund. Where the Commissioner of Internal Revenue, in a case within the scope of his authority and jurisdiction, has ordered a refund, a court cannot inquire as to the sufficiency of the evidence before him,[17] and neither the Comptroller of the Treasury nor any accounting officer has authority to review the Commissioner's decision.[18] Decisions by the Commissioner of Internal Revenue, in cases where a refund is directed, are binding and, in the absence of fraud, or mistake of calculation, not subject to revision.[19] The Commissioner's decision is conclusive as to the questions of fact,[20] but apparently not as to questions of law.[21] His decisions are in the nature of awards made by arbitrators, and generally speaking bind both the claimant and the Government. A refund may be impeached for fraud, want of jurisdiction, mistake apparent in the certificate, or for such irregularities as would avoid an award.[22] The Commissioner of Internal Revenue may reconsider and revoke an allowance for refund at any time before the allowance is paid, but whether a commissioner has power to revoke an allowance made by his predecessor is not clear.[23] Where one Commis-

16 See Chapter 36.

17 Woolner v. U. S., 13 Ct. Cls. 355.

18 Bank of Greencastle v. U. S., 15 Ct. Cls. 225.

19 Dugan v. U. S., 34 Ct. Cls. 458.

20 U. S. v. Wright, 11 Wall. 648.

21 6 Comp. Dec. 259.

22 Dugan v. U. S., 34 Ct. Cls. 458; Cumming v. U. S., 22 Ct. Cls. 344.

23 Ridgway v. U. S., 18 Ct. Cls. 707.

sioner recommended the allowance of the claim and referred the matter to the Secretary of the Treasury for advisement, a succeeding Commissioner to whom the matter was referred back could reject the claim.[24] The Commissioner is not precluded from allowing a claim for refund because a former Commissioner rejected a claim for abatement, and he is authorized to reconsider and allow a claim which he had, through error of law, previously rejected. An application for the refund of taxes, though informal or defective, may be regarded as a claim, so far at least as to permit a formal amendment to be filed after the statute of limitations has run.[25] The Commissioner of Internal Revenue has no authority to remit the 50% penalty unless it is illegally collected. The words "wrongfully collected" are construed as synonymous with the words "illegally collected." No equity powers are conferred on the Commissioner, and the Commissioner is authorized, not obliged, to refund.[26]

STATUTE OF LIMITATIONS. All claims for refund must be presented to the Commissioner of Internal Revenue within two years next after the cause of action accrued.[27] Presentation to the collector is equivalent to presentation to the Commissioner.[28] Where a protest was held by the Commissioner to be an informal appeal, and a formal application for refund was thereafter acted upon, although made after the expiration of two years, his decision was held to be conclusive and could not

24 Stotesbury v. U. S., 23 Ct. Cls. 285.

25 14 Op. Atty. Gen. 615.

26 16 Op. Atty. Gen. 667; 13 Op. Atty. Gen. 439.

27 R. S., § 3228.

28 Real Estate Savings Bank v. U. S., 16 Ct. Cls. 335; 104 U. S. 728.

be set aside by the court.[29] Failure to make a claim for refund within two years after paying the tax is a bar to a suit thereon.[30]

When Statute of Limitation Is Extended. Although generally the provisions of Section 3228 limit all claims for refund to a period of two years after the tax has been paid, an extension of this time is granted in cases where, upon examination of any return of income made pursuant to the 1916 Law, the 1913 Law or the 1909 Law, it appears that amounts of tax have been paid in excess of those properly due. In such cases the taxpayer is permitted to present a claim for refund, notwithstanding the provisions of Section 3228.[31] This provision was inserted as a remedy in cases where an agent of the Treasury Department makes an examination of a taxpayer's books within three years after a return has been filed and discovers undisclosed income. An examination may also disclose an overpayment, as well as undisclosed income, in which case the result of the examination may operate to the benefit of the taxpayer as well as to the benefit of the Government, regardless of the statute of limitations. Claims once rejected by the Commissioner, because of the statute of limitation in existence at that time, may be reopened under this provision, if the adjustment necessitates an examination of the return, but not otherwise.[32]

Procedure. The provisions for claiming refund must be strictly complied with.[33] Claim for the refunding

29 First Nat. Bank of Greencastle v. U. S., 15 Ct. Cls. 225.

30 Kings County Savings Institution v. Blair, 116 U. S. 200.

31 Act of September 8, 1916, § 14.

32 T. D. 2396.

33 Public Service Railway Co. v. Herold, 219 Fed. 301; Public Service Gas Co. v. Herold, 277 Fed. 496.

of assessed taxes and penalties must be made out upon the form prescribed by the Government. The burden of proof rests upon the claimant. All the facts relied upon in support of the claim must be clearly set forth, under oath.[34] The practice is to obtain a copy of the form from the local collector, prepare it according to instructions thereon, and file it with the local collector for further action. The collectors of internal revenue and revenue officers are forbidden to prepare affidavits for persons claiming remission of taxes or penalties under the internal revenue law.[35] An appeal for abatement or refund is imperfect if it does not have endorsed thereon the affidavit of the deputy collector and certificate of the collector required by the regulations,[36] but this is a matter of action within the Department.

Suits to Recover Taxes. If a claim is rejected by the Commissioner, a judicial remedy is given the taxpayer by an action against the collector or the United States. If the claim is allowed by the Commissioner and payment refused by the accounting officers, a suit may be brought directly against the Government in the Court of Claims.[37] The allowance of the claim by the Commissioner may be used as the basis of an action against the United States in the Court of Claims, when payment is not made by reason of the refusal of any of the officers of the Department to pass or to pay the claim, and it will be prima facie evidence of the amount that is due, and puts on the Government the burden

34 Reg. 14 Rev. The form to be used in claiming refund is officially known as Form 46.

35 T. D. 2443.

36 Hastings v. Herold, 184 Fed. 759.

37 Edison Electric Illuminating Co. v. U. S., 38 Ct. Cls. 208.

of showing fraud or mistake.[38] Before a suit can be commenced to recover taxes erroneously or illegally assessed or collected, or upon any penalty claimed to have been collected without authority, or for any sum alleged to have been excessive or in any manner wrongfully collected, an appeal must be made to and a decision rendered by the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. If such decision is delayed more than six months from the date of appeal, the suit may be brought at any time within the period provided by Section 3227, Revised Statutes, without first having a decision of the Commissioner.[39] Section 3227 provides that no suit to recover taxes wrongfully collected may be maintained in any court, unless it is brought within two years next after the cause of action accrued. Under Section 3226 no suit can be maintained unless the taxpayer appeals to the Commissioner of Internal Revenue. This appeal must be made within two years after the cause of action accrued. The accrual of the cause of action is at the date the tax is illegally assessed or collected. The date when the collector receives the money in payment of the tax is considered to be the date when the wrongful act is done by the United States. For example, if a tax is paid on June 28, 1917, the claim for refund must be filed on or before June 28, 1919, and suit may then be commenced not less than six months after filing the claim for refund, and not more than two years after the Com-

[38] U. S. v. Real Estate Savings Bank, 104 U. S. 728; Kaufman v. U. S., 96 U. S. 567.

[39] R. S., § 3226.

missioner makes his decision on such claim for refund.[40] The claimant is not required to bring suit within two years and six months after filing the claim for refund, but may, at his election, await the decision of the Commissioner and, if adverse, bring suit within two years thereafter.[41] The rejection of a claim, by the Commissioner of Internal Revenue, must be on the merits and not for irregularity in the form in order to support an action.[42] If an imperfect claim is filed within two years, it seems to be within the statute, although the corrected application is not made within that time, and if suit is brought within two years after rejection of the corrected claim, it is within the statute, although more than two years have expired since the first rejection. If the application for refund was filed more than two years after paying the tax, suit cannot be maintained, and the fact that the Commissioner rendered an adverse decision on the application, when filed, does not operate to extend the time.[43]

SUIT AGAINST COLLECTORS. The collector who exacted the tax may be sued for the recovery thereof, but an action thereon canot be commenced against his successor in office. The remedy lies in an action against

40 New York Mail and Newpaper Transportation Co. v. Anderson, 234 Fed. 590.

41 Merck v. Treat, 174 Fed. 388; Cheatham v. U. S., 92 U. S. 85; Kings County Savings Institution v. Blair, 116 U. S. 200; Commissioners v. Buckner, 48 Fed. 533; Christie-Street Commission Co. v. U. S., 136 Fed. 326, affirming 129 Fed. 506; Farrell v. U. S., 167 Fed. 639; Schwarzschild and Sulsberger v. Rucker, 143 Fed. 656; Hicks v. James' Administratrix, 48 Fed. 542; aff'd 110 U. S. 272.

42 Hicks v. Administratrix, 48 Fed. 542; aff'd 110 U. S. 272.

43 Public Service Ry. Co. v. Herold, 219 Fed. 301.

the collector to whom the tax was paid, or in an action against the United States.[44] It has been held that an action of *assumpsit* may be maintained against the collector who actually exacted the tax, and such action can be revived against the personal representative of the deceased collector.[45] When once an action has been lawfully commenced against a collector, it does not abate by reason of the expiration of his term, but in such event the court may, under the express provisions of the Act of February 8, 1899,[46] allow the suit to be maintained against his successor.

SUITS AGAINST THE UNITED STATES. Suit for recovery of taxes alleged to have been wrongfully assessed and collected may be maintained directly against the United States under the so-called Tucker Act.[47] In answer to the question, "Can the plaintiff bring suit to recover taxes, alleged to have been wrongfully assessed and collected under the corporation tax law, directly against the United States under the Tucker Act, other requirements of law having been complied with, or is its remedy against the Collector of Internal Revenue by whom the assessment and collection were made" it was held that the question was no longer

44 Roberts v. Lowe, 236 Fed. 604. In this case the court said the latter remedy was apparently authorized by the case of U. S. v. Emery, 237 U. S. 28; 35 Sup. Ct. 499; 59 L. Ed. 825. As to suing collector personally under a state law for damages in wrongfully collecting taxes, see Public Service Ry. Co. v. Herold, 229 Fed. 902, 910.

45 Patton v. Brady, Executrix, 184 U. S. 608, 22 Sup. Ct. 493; 46 L. Ed. 713.

46 30 Stat. L. 822, c. 121.

47 Judicial Code § 24, ¶ 20; Ch. 397, 24 Stat. 635 (U. S. Compiled Stats. p. 3635).

open.[48] The Tucker Act refers to original suits, and does not permit a recovery of demands against the United States on counterclaims.[49]

PROTEST AND DURESS. In order to maintain an action for the recovery of taxes it is necessary that the tax shall have been paid under protest and duress. For a discussion of this subject see the chapter on assessment and payment of the tax.[50]

Recovery of Interest. It is a well-settled principle that the United States are not liable to pay interest on claims against them, in the absence of express statutory provision to that effect. It has been established as a general rule in the practice of the Government that interest is not allowed on claims against it, whether such claims originate in contract or in tort; whether they arise in the ordinary business of administration, or the private acts of relief by Congress on special application. The only recognized exceptions are where the Government stipulates to pay interest, and where interest is given expressly by an Act of Congress, either by the name of interest, or by that of damages. Not only is this the general principle and settled rule of the executive department of the Government, but it has been the rule of the Legislative Department, because Congress, though well knowing the rule observed at the Treasury, and frequently invited to change it, has refused to pass any general law for the allowance and payment of interest on claims against the Govern-

48 Emery, Bird Thayer Realty Co. v. U. S., 198 Fed. 242, citing Christie-Street Commission Co. v. U. S., 136 Fed. 326.

49 U. S. v. Nipissing Mines Co., 206 Fed. 431.

50 See Chapter 36.

ment.[51] Where a person accepts from the Government without objection a refund of a sum illegally exacted he gives up his right to sue for interest.[52] The ground for refusal to allow interest is the presumption that the Government is always ready and willing to pay its ordinary debts. When, however, an illegal tax has been collected, the citizen who has paid it, and has been obliged to bring suit *against the collector,* is entitled to interest in the event of recovery from the date of the illegal exaction.[53] In a case where there had been a delay of thirty years in prosecuting a claim to recover internal revenue taxes, interest was not allowed from the date of payment of the taxes, but was allowed from the time of commencing the suit.[54] It seems clear that in a suit against a collector of internal revenue interest may be recovered whether or not the same rule applies to suits against the United States.[55] On recovery of a judgment against a collector of internal revenue for the amount of an internal revenue tax illegally collected, the plaintiff is entitled to have the judgment state that it is with interest.[56] Where judgment is recovered in an action against a collector, interest may be recovered up to the time final judgment is entered and a certificate from the trial court that there was probable cause for the collection of the tax has been given. Upon giving such certificate the claim becomes one against the United States, stopping the right to further interest, unless a review of the judgment by an appellate court is obtained, in which event

51 U. S. v. Bayard, 127 U. S. 260, 8 Sup. Ct. Rep. 1156.

52 Stewart v. Barnes, 153 U. S. 456.

53 Erskine v. Van Arsdale, 15 Wall. 75.

54 Burrough v. Abel, 105 Fed. 366.

55 Conant v. Kinney, 162 Fed. 581.

56 New York Mail and Newspaper Transportation Company v. Anderson, 234 Fed. 590.

the judgment upon the mandate of the appellate court will be treated as a final judgment, to the rendition of which interest will be allowed, unless the plaintiff unduly delays the presentation of his claim.[57] A suit against a collector is a private suit and there is no claim against the Government until a certificate of probable cause, under Section 989, Revised Statutes, has been obtained from the court, at which time the Government assumes a definite liability of the collector, which does not include the payment of interest thereafter; neither is there any further personal liability on the part of the collector. The interest which may be recovered is that put into the judgment before there is any certificate of probable cause, and if none has been put in, the Government assumes no part of the liability of the defendant. The liability assumed by the Government includes interest and costs forming part of the recovery, but does not include interest after judgment.[58]

Costs. Section 3220 of the Revised Statutes authorizes the Commissioner of Internal Revenue to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any collector, deputy collector, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty. Under this section costs may be recovered against the collector.[59] Judgment is usually given in the District Court for costs and interest.

57 Klock Produce Co. v. Hartson, 212 Fed. 758.

58 White v. Arthur, 10 Fed. 80.

59 De Bary v. Carter, 102 Fed. 130. However, see Treat v. Farmers Loan and Trust Company, 185 Fed. 760, 763, as to costs in the Supreme Court and Circuit Court of Appeals.

CHAPTER 40

INFORMATION AT THE SOURCE

A new administrative provision added to the 1916 Law [1] requires that information be furnished by brokers as to their customers, by corporations as to dividend payments and interest payments, by first collection agencies as to foreign items, and by persons, corporations and partnerships generally as to payments of income to others, in order that the Treasury Department may have data on which to audit the returns of annual net income. Rulings and regulations applying these provisions have not been issued at the time of this writing. The several classes of payments which are required to be reported, and the provisions with respect to each, are discussed in the following paragraphs.

Miscellaneous Income, Gains and Profits. Payments of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable gains, profits and income of $800 or more in any taxable year must be reported. "Fixed or determinable gains, profits and income" as used in this section would seem to include payments of all the kinds expressly enumerated and all payments of a simi-

[1] Act of September 8, 1916, §§ 26, 27 and 28, added by Act of October 3, 1917.

lar kind or nature. In the case of collection at the source the payments must be annual or periodical, while in the case of information at the source the law does not contain such limitation. Hence any payments of the kind described, whether made in isolated cases or from time to time, must be reported. It is immaterial whether or not an employee is employed for the full year or his wages are fixed in advance or paid according to the amount of work he does.[2] The only exception is in the case of payments which do not amount to $800 or more in any taxable year. If the aggregate of several payments made to the same payee equals or exceeds $800 in any taxable year the gross amount should be reported. The payments may be from different forms of income, as, for instance, from interest and rent, or interest and salary. In such cases, it seems, the total is required by law to be reported, if the aggregate of all payments in the year to the same payee equal or exceed $800. The income required to be reported under this provision of the law and subject to the minimum limitation of $800 does not include any of the classes of income specifically required to be reported as indicated in the following paragraphs.[3]

Gains and Losses of Customers of Brokers. Every person, corporation, partnership or association, doing business as a broker on any exchange or board of trade or other similar place of business, is required to disclose to the Commissioner of Internal Revenue the names of customers for whom such broker has trans-

[2] Letter from Treasury Department dated October 25, 1917; I. T. S. 1917, ¶ 2470.

[3] Act of September 8, 1916, § 28, added by Act of October 3, 1917.

acted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers.[4]

Dividends on Stock of Taxable Corporations. Every corporation subject to the tax imposed by the 1916 Law is required to disclose its payments of dividends, whether made in cash, or its equivalent, or in stock, including the names and addresses of stockholders and the number of shares owned by each, and the tax years and the applicable amounts in which such dividends were earned.[5]

Dividends on Stock of Foreign Corporations. It seems that the law contemplates that if the foreign corporation is a "resident" corporation, subject to the tax imposed by the 1916 Law, having an office or place of business in this country, and paying its dividends from such office in this country, it shall report its dividend payments in the same manner as indicated in the preceding paragraph. When dividends from stock of foreign corporations are not payable in the United States the duty of reporting the name of the payee falls upon the first collection agency collecting such foreign payment.[6]

Interest on the Obligations of Domestic Corporations. In the case of payments of interest upon bonds and mortgages or deeds of trust or other similar obligations of corporations the name of the payee is to be reported regardless of the amount of interest paid.[7]

4 Id. § 27.
5 Id. § 26.
6 Id. § 28.
7 Id. § 28.

Interest on Obligations of Foreign Corporations. Where interest is paid on the obligations of foreign corporations from an office in this country, the intent of the law seems to be that the corporation, or its paying agent, shall report each payment. If such interest is not payable in the United States the first collection agency collecting the same is required to report the payment.[8]

Interest on Bonds of Foreign Countries. If interest on the bonds of foreign countries is paid in this country it seems that the paying agent of the foreign country is required to report each payment, regardless of the amount thereof. It is likely the names of non-resident alien payees will not be required, as such information would not be necessary to effectuate the law. If such interest is not payable in the United States the first collection agency in this country is required to report each payment, regardless of the amount thereof.[9]

Interest on Obligations of the United States. The law expressly provides that no information at the source is required in the case of payment of interest on obligations of the United States.[10]

State and Municipal Bonds. Although the interest received from state and municipal bonds is not subject to tax, the law does not expressly exempt such payments from the requirements as to information at the source; neither does it expressly include such payments. Procedure in this respect will depend upon rulings of the Treasury Department.

8 Id. § 28.
9 Id. § 28.
10 Id. § 28.

Procedure in Paying Income. In order that the payor of the income required by the law to be reported, may obtain the necessary information the law expressly provides, except in the case of reports of dividend payments and reports by brokers, that the name and address of the recipient of income shall be furnished upon demand to the person, corporation, or partnership paying income. No form of certificate to be used for this purpose has been prescribed at the present writing. All payers of income should obtain in some form the name and address of the recipient of such payment. It does not seem necessarily that the name of the owner of the income be obtained, as the law merely requires that the payor shall report the amount of the gains, profits and income and the name and address of the *recipient* of such payment.[11]

Return of Information at the Source. The law provides, with respect to dividend payments of corporations, that the return made by the corporation shall state the names and addresses of the stockholders, the number of shares owned by each, and, impliedly, the amount of dividend paid to each, during the period covered by the report, together with information as to the tax years and the applicable amounts in which such dividends were earned. With respect to the return to be made by brokers, the law provides that it shall state the names of customers (and impliedly their addresses) for whom such broker has transacted any business, with such details as to profits, losses, or other information which the Commissioner may require, as to each of such customers. In the case of all other payments the law requires the name and address of

11 Id. § 28.

the recipient of the payment and the amount of the gains, profits and income paid to him.

WHEN DUE. The law specifies no time for the filing of this return, but provides that the return shall be made in all cases when required by the Commissioner of Internal Revenue, under such rules and regulations, and in such form and manner as may be prescribed by him, with the approval of the Secretary of the Treasury.

WHERE FILED. The act does not specify where such return shall be filed. Forthcoming regulations on the subject will state whether the return is to be filed with local collector or with the Commissioner of Internal Revenue.

Collection of Foreign Payments. Where foreign payments of interest upon the bonds of foreign countries and interest from the bonds and dividends from the stock of foreign corporations, are made to residents of this country, individuals, partnerships or corporations, the first collection agency in this country is required to report the name and address of the recipient of such payment and the amount thereof. "First collection agency" as used in this chapter means the person, corporation or partnership, undertaking as a matter of business or for profit, the collection of foreign payments of such interest or dividends by means of coupons, checks or bills of exchange.[12] The law provides that "all persons, corporations, partnerships, or associations, undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends

12 Id. § 28.

by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner of Internal Revenue, and shall be subject to such regulations enabling the Government to obtain the information required under this title, as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe; and whoever knowingly undertakes to collect such payments as aforesaid without having obtained a license therefor, or without complying with such regulations, shall be deemed to be guilty of a misdemeanor and for each offense be fined in a sum not exceeding $5,000, or imprisoned for a term not exceeding one year, or both, in the discretion of the court."[13]

License. Application for license for the collection of foreign items should be made to the collector of the district in which the business is to be carried on. Upon the acceptance of such application the collector will issue to the applicant, without cost, a license which will continue in force until revoked or cancelled.[14]

13 Act of September 8, 1916, § 9 (f), as amended by Act of October 3, 1917.

14 Reg. 33, Art. 55.

CHAPTER 41

COLLECTION OF TAX AT THE SOURCE

Before the Amendment of October 3, 1917, the 1916 Law, and the 1913 Law, required collection of the tax at the source on payments of income to citizens and residents of the United States, as well as on payments to non-resident aliens. The Amendment abolished withholding at the source with respect to citizens and residents, except in the case of the payment of interest on corporate bonds containing covenants to pay the tax.[1] On the payment of such interest to individuals, 2% is required to be withheld at the source, as more fully explained in the following paragraphs. At the present time withholding at the source is required, (a) on payment of fixed or determinable annual or periodical gains, profits and income (except dividends) of any non-resident alien individual; (b) on payment of income derived from interest upon bonds of domestic or other resident corporations by non-resident foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein; (c) on payment of income derived from dividends on the stock of domestic or other resident corporations by non-resident foreign corporations not engaged in business or trade within the United States and not having an office or place

[1] Act of September 8, 1916, § 9 (c) as amended by Act of October 3, 1917.

of business therein and (d) on payment of interest on bonds of corporations to individuals, citizens, residents or aliens, if such bonds, or the mortgages under which they are issued, contain a covenant to pay any portion of the income tax for the bondholder, or to pay the interest without deduction for any tax which the corporation may be required or permitted to pay thereon or retain therefrom under any law of the United States. The Amendment is retroactive to January 1, 1917, and any normal tax withheld from income paid to citizens or residents in 1917, other than interest described in (d) above, is required by the law to be released and paid over to the persons from whose income such tax was withheld.

Definitions. In order to clarify the discussion in this chapter, the following words and phrases will be used in the sense defined, unless otherwise indicated in the text.

FIXED OR DETERMINABLE INCOME. The phrase as used in the law includes interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, but expressly excludes income derived from dividends on capital stock, or from the net earnings of a corporation, joint stock company, or association, or insurance company, which is taxable upon its net income.[2] Under the 1913 and 1916 Laws, the Treasury Department defined the term in a series of regulations, as follows:[3]

[2] Id. § 9 (b) as amended by Act of October 3, 1917.

[3] Although the tax is required to be withheld at the source only on payment of fixed or determinable income of non-resident aliens, the payee of other income may be required to account for the tax as an agent for the non-resident principal. See Chapter 6.

Commissions. Where an individual works on a straight commission basis and, in earning his commissions, incurs and personally pays traveling and other expenses, the amounts paid to him as commissions are not fixed and determinable income. If the agent incurs and pays no necessary business expenses in earning his commissions, the amount paid him is fixed and determinable income.[4]

Profit Sharings. The amount received as a share of the profits of the employer is fixed and determinable income.[5]

Bonus. A bonus paid in addition to salary is fixed and determinable income[6] unless it is a mere gift or gratuity.

Per Diem salaries paid on a straight basis of compensation for services rendered is fixed and determinable income, unless the employee is required by the terms of his employment or contract to pay therefrom his own travel and other legitimate expenses incident to the business of his employment.[7]

Rent is fixed and determinable income subject to withholding, and this is true whether payment is made in cash or in notes.[8] Where permanent improvements are made by a tenant under the terms of a lease the value thereof is considered income to the landlord to be accounted for by the landlord as gain or profit at the termination of the lease, but the amount is not fixed or determinable income.[9]

[4] Letter from Treasury Department dated January 12, 1917, I. T. S. 1917, ¶ 2059

[5] T. D. 2090.

[6] T. D. 2135.

[7] T. D. 2135.

[8] T. D. 2090.

[9] T. D. 2442.

Partnership Salaries. Salaries stipulated by contract or articles of agreement between partnership members constitute fixed and determinable income. But where, by agreement or otherwise, members of the firm are permitted to draw either stated or unstated sums in advance of an annual or periodic determination of partnership profits, no withholding is required, as these sums do not represent fixed or determinable income within the meaning of the law.[10] There is no withholding against the partners on payment of the net distributive shares of the income of the partnership.

When a note is given in payment of fixed and determinable income the duty of withholding the tax is imposed upon the maker of the note.[11]

Exempt Income. Although exempt income may be fixed and determinable no withholding is required upon the payment thereof.[12]

Income of an individual which is not fixed or certain and not payable at stated periods, or is indefinite or irregular as to amount or time of accrual, is not subject to withholding at the source, such as incomes of farmers, merchants, agents (unless the compensation is in the form of commissions as indicated above) lawyers (except annual retainers), doctors, authors, inventors, and other professional persons whose income is irregular or indefinite.[13]

Interest as a general rule is held to be fixed or determinable income and subject to withholding, but interest paid by banks, bankers, trust companies and other bank-

10 Memorandum from Treasury Department, I. T. S. 1917, ¶ 2282.

11 Reg. 33, Art. 68.

12 T. D. 1890.

13 T. D. 1890 and T. D. 2090. See, however, Chapter 6.

ing institutions receiving deposits of money is not subject to withholding.[14]

Royalties. Where royalties or rentals accrue under the terms of a lease or agreement, as for instance, royalties for the right to mine or produce or remove minerals or oil or other natural deposits, the royalty or rental is not fixed or determinable income if it represents a partial return of capital originally invested in the lands by the lessor.[15]

DIVIDENDS. The term dividends as used in this chapter means dividends, as defined in the law [16] upon the capital stock or from the net earnings of domestic or other resident corporations, joint-stock companies or associations, and insurance companies.[17] The term includes dividends paid in cash, scrip or stock.

BOND INTEREST. The term as used in this chapter means interest upon bonds and mortgages, or deeds of trust or similar obligations of domestic or other resident corporations, joint-stock companies or associations, and insurance companies.[18] The term does not include interest payments on ordinary bankable commercial paper of corporations or ordinary promissory notes of corporations not exceeding one year in time.[19]

14 Reg. 33, Art. 67.

15 Letter from Treasury Department dated March 10, 1916, I. T. S. 1917, ¶ 750.

16 See Chapter 23.

17 Act of September 8, 1916, § 13 (f).

18 Act of September 8, 1916, § 13 (e) as amended by Act of October 3, 1917.

19 T. D. 2090.

COVENANTS TO PAY THE TAX. The term as used in this chapter means a covenant, contract or provision in the bonds or the mortgage or other obligations of a corporation by which the obligor agrees to pay any portion of the income tax imposed by the 1916 Law or the 1917 Law upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[20]

DOMESTIC CORPORATIONS. The term as used in this chapter means a corporation as defined in Chapter 12 of this book, that is, a corporation, joint-stock company, association or insurance company organized in the United States.

RESIDENT CORPORATIONS. The law refers to domestic "or other resident corporations" [21] but does not define the term. As used in this chapter it means a corporation, joint-stock company, association or insurance company organized under a foreign jurisdiction and having a place of business in this country from which interest on its bonds and dividends on its stock are paid.[22]

[20] Act of September 8, 1916, § 9 (c) as amended by Act of October 3, 1917. See Chapter 42.

[21] Act of September 8, 1916, § 13, ¶¶ (e) and (f).

[22] It seems to have been the intention of Congress to apply the provisions with respect to withholding to such foreign corporations as are within the jurisdiction of the Federal Government. Although a foreign corporation may have one or more branch offices here, if interest on its bonds, or dividends on its stock, are not payable in the United States, it does not seem that the law intends the corporation to withhold the tax at the source.

WITHHOLDING AGENTS. The term as used in this chapter refers to the individual, partnership or corporation required under the provisions of the law to withhold the tax at the source and to report and pay over the amount thereof to the Government. Corporations may appoint withholding and paying agents to act for them in collecting the tax at the source and making the returns of the amounts so collected by filing a notice with the local collector.[23]

Withholding on Payment of Fixed or Determinable Income. The law provides that the tax shall be withheld at the source upon payments of fixed or determinable annual or periodical gains, profits or income of any non-resident alien. The phrase fixed or determinable income is defined in a preceding paragraph of this chapter. It should be noted that the withholding provisions do not apply unless the income is not only fixed or determinable but also annual or periodic. Although payments of other income to non-resident aliens is not subject to withholding at the source, the resident in this country having receipt, control or custody of such income may be required, as agent for the non-resident principal, to report the amount of such income and to account for the normal tax and the supertax thereon, as indicated in a preceding chapter.[24] Persons paying fixed or determinable income to non-resident aliens are authorized and required by the law to deduct and withhold such sums as will be sufficient to pay the normal tax imposed thereon by the 1916 Law.[25] No normal tax is imposed on non-resident aliens

23 Reg. 33, Art. 38.

24 See Chapter 6.

25 Act of September 8, 1916, § 9 (b) as amended by Act of October 3, 1917.

by the 1917 Law.[26] This means that upon all payments of income to non-resident aliens 2% must be withheld at the source by the withholding agent and paid over to the Government. There is no withholding at the source on payments of fixed or determinable income to citizens or residents or to corporations or partnerships, except as indicated in the following paragraphs.

Withholding on Payment of Dividends. The tax is withheld on payment of dividends only in cases where the dividend is paid to non-resident foreign corporations not engaged in business or trade within the United States and not having any office or place of business therein.[27] The law requires the corporation paying the dividend, or its paying agent, to withhold the tax of 2% imposed by Section 10(a) of the 1916 Law. This amount is to be withheld regardless of the year in which the dividend was earned by the paying corporation.[28] It has been held by the Treasury Department that the tax of 4% imposed on foreign corporations by the 1917 Law is not to be withheld at the source on payments of dividends,[29] since, for the purpose of assessing the tax imposed by the 1917 Law, corporations are permitted to deduct from their net incomes the amount of dividends received from other corporations taxable under that law.[30] Where stock, actually owned by a non-resident foreign corporation having no office or place of business in this country, stands on the books of the corporation

[26] Act of October 3, 1917, § 1.

[27] Act of September 8, 1916, § 13 (f).

[28] T. D. 2584.

[29] Letter from Treasury Department dated October 29, 1917, I. T. S. 1917, ¶ 2469.

[30] Act of October 3, 1917, § 4.

in the name of a nominal stockholder, the paying corporation will be required to withhold the tax at the source if it has knowledge of the fact that the actual owner is such a foreign corporation.[31] When stock dividends are paid, the Treasury Department suggests that a domestic corporation may protect itself by requiring the foreign corporation stockholder to deposit with it, prior to the payment of the stock dividend, an amount equal to the tax, or to issue stock or scrip in payment of the balance due on the stock after deducting the tax. In short, each corporation, so far as the law is concerned, must provide its own method for performing this duty.[32]

Withholding on Payment of Bond Interest. The statute requires withholding at the source on payment of bond interest (as defined above) to non-resident aliens, non-resident foreign partnerships not engaged in business or trade in the United States and not having an office or place of business therein, and non-resident foreign corporations not engaged in business or trade in the United States and not having an office or place of business therein. The amount to be withheld at the source depends upon the status of the owner of the income. If the income is owned by a non-resident alien, 2% of the payment is required to be withheld at the source; if the owner of the income is a foreign partnership no tax need be withheld at the source,[33] if the owner of the income

[31] Letter from Treasury Department dated October 23, 1917, I. T. S. 1917, ¶ 2467.

[32] Letter from Treasury Department dated April 10, 1917; I. T. S. 1917, ¶ 2188.

[33] This anomaly is due to the language of § 13 (e) of the 1916 Law, as amended by the Act of October 3, 1917, requiring the tax imposed by "subdivision (a) of § 10" of the 1916 Law to be withheld at the source, which section imposes no tax on partner-

is a foreign corporation, 6% of the payment is required to be withheld [34]

INTEREST ON BONDS CONTAINING COVENANTS TO PAY THE TAX. Withholding is not required on payment of bond interest to citizens and residents, unless the bond, mortgage, deed of trust or other similar obligation of the corporation contains a contract or provision by which the corporation agrees (a) to pay any portion of the income tax of the creditor or (b) to reimburse the creditor for any portion of the tax or (c) to pay the interest without deduction for any tax which the corporation may be required or permitted to pay thereon or retain therefrom under any law of the United States.[35] The corporation is relieved from withholding only if the person entitled to receive such interest files with it, on or before February 1st, a signed notice in writing claiming the benefit of the personal exemption under Section 7 of the 1916 Law.[36] The 1917 Law [37] provides that the normal tax imposed by that law shall not be withheld under this provision on payments of interest made prior to January

ships. It has, therefore, been held that income of such partnerships is not in fact subject to withholding at the source. (Letter from Treasury Department dated October 26, 1917, I. T. S. 1917, ¶ 2468).

[34] T. D. 2457.

[35] Act of September 8, 1916, § 9 (c) as amended by Act of October 3, 1917. This provision has been called "an excrescence on the law." Its purpose seems not to be so much to assist the Government in collecting the tax as to shift the burden of the tax from the creditor to the debtor corporation, a burden the corporation would not be required to assume were it not for the requirement that the tax be withheld at the source.

[36] Act of September 8, 1916, § 9 (c) as amended by Act of October 3, 1917.

[37] Act of October 3, 1917, § 3.

1, 1918, and that on payments of interest made after that date only one 2% normal tax shall be deducted and withheld under this provision, any further normal tax for which the recipient of such income is liable, under the 1916 Law or the 1917 Law, being payable by the recipient and not by the debtor corporation. If the covenant does not require the corporation to pay the tax imposed by the 1916 Law or the 1917 Law for the bondholder, no tax need be withheld.[37a] The practical effect of these provisions of the law is that where a corporation has issued bonds containing a covenant such as described above, it will be required to go through the motions of withholding 2% on all payments of interest to citizens or residents, unless a certificate is filed claiming exemption from the tax on such income. No tax will actually be withheld, since the interest will be paid in full under the terms of the covenant, and the corporation will pay the tax theoretically withheld. The citizen or resident receiving such income will state, in his return of annual net income, that a normal tax of 2% has been withheld at the source, and the tax assessed against him will be reduced to that extent. Upon payments of such interest to non-resident aliens, the corporation will be required to withhold only 2%, since the normal tax under the 1917 Law is not imposed on non-resident aliens. If the owner of the bond is a non-resident foreign corporation having no office or place of business in this country, the Treasury Department requires 6% to be withheld at the source, and the paying corporation will consequently assume the burden of a tax of 6% on all such payments. If a citizen or resident is not subject to the income tax by reason of the personal exemption to

[37a] Letter from Treasury Department dated November 21, 1917; I. T. S. 1917, ¶ 2511.

which he is entitled, he should file, on or before February 1st of the year following that in which the interest was paid, a certificate claiming exemption, as otherwise he will subject the paying corporation to an expense of 2% of the amount of interest, although no tax is justly due.[38] The normal tax required to be withheld by this provision of the law is required to be deducted only by the debtor corporation and should not be withheld by any bank or agency through which collection is made.[38a]

Against Whom the Tax Is Withheld. Although the foregoing paragraphs indicate the classes of taxpayers against whom the tax is withheld, the law will be re-stated under this heading for the sake of convenient reference.

INDIVIDUALS. The tax is withheld on payments to non-resident aliens of fixed or determinable annual or periodic income, including payments of bond interest, but not including payments of dividends. The amount to be withheld on all payments to non-resident aliens is 2%. The tax is withheld on payments to citizens and residents

38 In good conscience, the bondholder should in all cases apply a portion of his personal exemption to his income from interest of the kind described in this section, as the personal exemption is, according to the intent of the law, applicable to his income as a whole and not to his income from any particular source. Thus, if one-tenth of an individual's income is from interest of this character, one-tenth of his personal exemption should be applied against it, but it cannot be reasonably expected the average individual will adopt this course of procedure when the law places it within his power to apply his entire exemption to income from other sources, and to place upon the debtor corporation the burden of his tax to the extent of 2 per cent upon the full amount of interest on "tax-exempt" bonds.

38a Letter from Treasury Department dated November 13, 1917; I. T. S. 1917, ¶ 2480.

of interest on corporate bonds containing covenants to pay the tax, but only to the extent of 2%, as indicated in the foregoing paragraph on that subject.

PARTNERSHIPS. No tax is withheld upon payments to partnerships. Congress attempted to require the tax to be withheld upon payments of bond interest to non-resident foreign partnerships not engaged in business or trade in the United States and not having an office or place of business therein, but by a defect in the language of the law the present statute does not impose such requirement.[39]

CORPORATIONS. No amount is withheld on payments to domestic corporations or to foreign corporations which are engaged in business or trade in the United States or have an office or place of business therein. The tax is withheld on payments of bond interest and dividends to non-resident foreign corporations not engaged in business or trade within the United States and not having an office or place of business therein.[40] The amount to be withheld on payment of bond interest to such foreign corporations is 6%, and on payment of dividends, 2%.

FIDUCIARIES. The tax is withheld upon payments to fiduciaries who are citizens or residents of this country, or who have an office or place of business herein, in the same manner and to the same extent as in the case of citizens and residents. The tax is withheld on payments to foreign fiduciaries in the same manner and to the same extent as in the case of non-resident aliens.[41]

[39] See Note No. 33 of this chapter.
[40] See Page 464.
[41] See Page 468.

Fiduciaries are subject to all the provisions of the law which apply to individuals.[42]

AGENTS. The fact that an individual, partnership or corporation may have an agent within this country to collect and receive income does not operate to prevent withholding of the tax on payments of income to such agent in cases where payments of income direct to the principal would be subject to withholding. The appointment of an agent in this country does not in itself establish the residence of the principal in this country, for purpose of the income tax, nor does such appointment exempt the non-resident foreign corporation from the withholding provisions unless, in addition to the appointment of the agent, the corporation is engaged in business or trade in this country or has an office or place of business herein. Agents of non-resident aliens, or foreign partnerships or corporations subject to the withholding provisions should proceed, in collecting income for their principals, in the same manner as the principals would proceed if acting for themselves.[43]

NOMINAL STOCKHOLDERS. The tax is withheld on payment of dividends of nominal stockholders in all cases where the paying corporation knows the actual owner is a non-resident foreign corporation not engaged in business or trade in the United States and not having an office or place of business therein. The tax is also withheld on payments of dividends to nominal stockholders who are such foreign corporations, regardless of who the

[42] Act of September 8, 1916, § 8 (c) as amended by Act of October 3, 1917.

[43] See Chapter 6 on resident agents.

actual owner may be, unless a certificate is filed with the paying corporation disclosing the actual owner.[44]

Procedure in Collecting Income. The Treasury Department has, at the time of this writing, issued no rulings governing the procedure in collecting income from sources within this country by those against whom the tax is required to be withheld. No radical change in the system evolved under the 1913 and 1916 Laws is likely, but the number of ownership certificates will be reduced and the procedure simplified. In the case of interest or other income payable "to bearer," that is to the person presenting the coupons or other evidence entitling him to receive the income, a certificate, or certificates, will be required disclosing the name, address and status of the owner of the income. The one paying such income will withhold the amount required by law in accordance with the facts revealed by such certificates. As a non-resident alien can in no case claim exemption from withholding at the source, or prevent withholding by any action on his part, a certificate substantially in the form now required to be used by non-resident alien individuals, firms, organizations and fiduciaries[45] will be prescribed. The present form of such ownership certificate is and will be used until the Treasury Department issues new regulations on the subject.

Ownership Certificates. A duly authorized agent may sign ownership and exemption certificates for his principal, in which case the withholding agent or bank with whom the certificate is filed must stamp or write on the face of such certificate, "Satisfied as to identity

44 See Chapter 7 on nominal stockholders.

45 Form 1004.

and responsibility of agent," giving the name and the address of the person so certifying. Before so certifying, the agent may be required to furnish evidence of his authority to act, which will be retained by the one so certifying. Certificates so endorsed may be accepted by all others through whose hands they pass, without question as to the authority of the agent.[46] This endorsement is not required when the certificate is signed on behalf of the owner by reputable banks or collecting agents under the regulations providing therefor.[47]

Any one may print the forms of ownership and exemption certificates. Forms printed by private parties must conform in size, type, color and weight to the forms printed by the Government.[48] The size is 8 by 3½ inches, reading from left to right along the 8-inch dimension. The paper corresponds in weight and texture to white writing paper, 21 by 32, about 40 pounds to the ream of 500 sheets. The color is yellow for certificates used in claiming exemption (Form 1063 and 1071) and white for those used in not claiming exemption. (Form 1004). Ownership certificates to be used by foreigners in collecting interest may carry, directly under each line of the English text, a translation of the text in a foreign language. In executing these certificates, however, all blanks to be filled in with amounts must be filled in by using United States dollar values. The certificates must also be of the same size as those carrying only the English text.[49]

46 Reg. 33, Art. 43.

47 Letter from Treasury Department dated April 16, 1914; I. T. S. 1917, ¶ 111.

48 T. D. 2325, T. D. 2399.

49 T. D. 1926.

FORM 1004. This form is used in presenting for collection or payment coupons detached from bonds and other obligations of domestic corporations owned by non-resident alien individuals, fiduciaries, partnerships and corporations.[50] The form may be used by recognized banks and bankers who are authorized to act for the non-resident owners.[51]

FORM 1071. This form may be used by responsible banks and bankers, either foreign or domestic, for or on behalf of non-resident aliens, in claiming exemption from the tax on dividends from the stock or interest on the bonds of foreign corporations, payable in this country.[52] This form is primarily intended to be used by residents, banks and bankers, acting on behalf of non-resident aliens, but where the non-resident alien acts without the intervention of a bank or banker, he may sign this form after modifying it to show personal ownership of the dividends or interest, as the case may be.[53]

SUBSTITUTE CERTIFICATES. Under the 1913 and 1916 Laws responsible banks, bankers and collecting agencies, in this country or in foreign countries [54] were permitted to substitute their own certificates for the ownership

50 T. D. 2399.

51 T. D. 2325. Until the present law is changed to require withholding against foreign partnerships, such organizations should use Form 1001.

52 T. D. 2030, T. D. 2325. An early ruling also permitted the use of Form 1063 by non-resident aliens in claiming exemption from income tax on dividends payable in the United States from stock of foreign corporations. (T. D. 2012.)

53 Letter from Treasury Department dated June 13, 1916, I. T. S. 1917, ¶ 122.

54 Reg. 33, Art. 40.

certificates of the owners of coupons. The purpose of making such substitution is to prevent disclosure of the actual owner to the various banks and collecting agents through which the coupon and its accompanying certificate might pass before being finally presented to the paying corporation. When the ownership certificates were so detached they were required to be forwarded to the Commissioner of Internal Revenue, not later than the 20th day of the month succeeding that in which the coupons were thus received for collection.[55] The substitution certificate[56] recited that the bank or collecting agent had detached the ownership certificate from the accompanying coupons, endorsed the same as required by the Treasury regulations, and would forward such certificate to the Commissioner of Internal Revenue at Washington, in accordance with the regulations. The substitute certificate was thereafter handled as the ownership certificate would have been handled, finally being transmitted to the local collector by the paying corporation, and by the local collector transmitted to Washington where the original ownership certificate, theretofore sent to the Commissioner, was finally matched up with the substitute. Banks availing themselves of the privilege of substituting their own certificates were required to keep a complete record of each transaction showing (a) the serial number of item received, (b) date received, (c) name and address of person from whom received, (d) name of debtor corporation, (e) class of bonds from which coupons were cut, (f) face amount of coupons, (g) exemption from tax, if any was claimed by the owner. Such substitute certificates

[55] T. D. 1903.

[56] Form 1058 was used when exemption was claimed and Form 1059 when exemption was not claimed.

were required to be numbered consecutively and corresponding numbers given the original certificate detached from the coupons.[57] When the certificate of the owner was removed it was required that an endorsement be made thereon, by the collecting agency removing the same, showing the number of the ownership certificate, the name of the collection agency, the date of the certificate and a statement that "the counterpart of the within certificate was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable."[58] Substitute certificates could be signed by a fac-simile rubber stamp providing proper authority was given by the bank or collecting agent to the person using such fac-simile certificate and a notice of such authorization, bearing the real and fac-simile signature of the person so authorized, was duly filed with the Commissioner. The use of substitute certificates has been discontinued as to coupons presented for collection on behalf of non-resident aliens, corporations and partnerships.[59]

Release of Amounts Withheld. Where amounts have been withheld by withholding agents in excess of the tax liability of the non-resident alien, such non-resident alien may obtain a release of the excess amounts withheld by following the procedure indicated in the chapter on non-resident aliens.[60]

Abatement and Refund. Where the withholding agent has reported the amounts withheld to the Government and the tax has been assessed thereon abatement

57 Reg. 33, Art. 40.
58 T. D. 1903.
59 T. D. 2589.
60 See p. 56.

may be claimed, in the manner indicated in the chapter on abatement and refund, either by the withholding agent against whom the assessment was made or by the person on account of whom such taxes were withheld.[61] If the tax has been paid by the withholding agent refund may be claimed as indicated in the same chapter.[62]

By Whom the Tax Is Withheld. The tax is withheld by the one paying the income whether the payor be an individual, a partnership, or a corporation. Special rules applying to certain classes of withholding agents are briefly summarized below.

BANKS. Banks, bankers and trust companies and other banking institutions receiving deposits of money are not required to withhold the normal tax on interest paid or accruing on such deposits, whether on open accounts or on certificates of deposit; but all such interest whether paid or accrued must be reported by the depositor.[63] This ruling applies if the depositor is a non-resident alien or a foreign corporation having no office or place of business in the United States.[64]

CORPORATIONS. Corporations are required to withhold the tax on payment of any fixed or determinable income to non-resident aliens, on bond interest and dividends paid to foreign corporations not engaged in business or trade in the United States and not having an office or place of business therein, and on payments of interest on bonds containing covenants to pay the tax to any

61 Reg. 33, Art. 33.

62 See pp. 437 and 440.

63 Reg. 33, Art. 67.

64 Letter from Treasury Department dated June 29, 1917, I. T. S. 1917, ¶ 2256.

individual bondholders. The amounts to be withheld and the duties with respect thereto are discussed elsewhere in this chapter.

DEBTORS. Resident debtors whether individuals, partnerships or corporations, including mortgagors, are required to withhold the tax on all payments of interest to non-resident aliens.

EMPLOYERS. Employers are required to withhold the tax on all salaries, wages or compensation paid to non-resident aliens except where the salary of the non-resident alien is not taxable under the law.[65]

FIDUCIARIES. Trustees, executors, administrators, conservators and other fiduciaries are required to withhold the tax on all payments of fixed or determinable annual or periodic income to non-resident aliens, including beneficiaries of the trust estate in their hands. For discussion of the special duties with respect to beneficiaries see the chapter on fiduciaries.[66]

LESSORS. Lessors and tenants paying rent to non-resident aliens, or their agents, are required to withhold the tax, as rent is fixed or determinable income within the meaning of the law. In computing the amount to be withheld the lessor should take into consideration such sums, if any, as are paid under the terms of the lease, as taxes, or other disbursements, for the landlord. Thus, if a tenant pays an annual rent of 10,000 in cash and in addition pays taxes of $1,000, the total amount on which

65 See Page 48 for discussion of salaries paid to non-resident aliens.

66 See Chapter 8.

withholding should take place is $11,000. While the value of permanent improvements made on the property by the tenant is income to the landlord, no withholding need be made with respect thereto since such income is not fixed or determinable.[67]

OFFICERS AND EMPLOYEES OF THE UNITED STATES. Officers and employees of the United States are required to withhold the tax on amounts of fixed or determinable income paid to non-resident aliens.

Duties of Withholding Agents. If the withholding agent knows that the one to whom he pays fixed or determinable incomes is a person or corporation against whom the tax is required to be withheld, an ownership certificate is not necessarily required from the payee, but the requisite amount is withheld without notice from or to the payee. Where payment is made to persons not known to the payee, as in the case of interest on bearer bonds, an ownership certificate is required from each payee disclosing his or its status and if the payee is one against whom withholding should take place the tax is withheld. If, in such cases, no ownership certificate is presented the payee is not required to make payment until the name and address of the recipient of the income is furnished.[68]

ON PAYMENT OF REGISTERED INTEREST. Corporations paying interest to registered owners of bonds are not required to obtain certificates of ownership, but will

67 See Page 459.

68 Act of September 8, 1916, § 28 added by Act of October 3, 1917.

withhold the tax in such cases where the records of the company disclose the fact that the owner of the bonds is a person or corporation against whom the tax is withheld.[69] The tax is withheld before sending out orders or checks for such interest to the registered owners, and the interest order or check is endorsed with the words "income tax withheld by debtor." An interest order or check bearing such indorsement may be presented for payment or collection without an ownership certificate being attached.[70]

On Payment of Dividends. Corporations paying dividends to non-resident foreign corporations, against which the tax is required to be withheld, are not required to obtain ownership certificates, but should withhold the tax in all cases where the records of the corporation show the stockholder to be a foreign corporation not engaged in business or trade in the United States and not having an office or place of business therein. If the corporation has knowledge of who is the actual owner of the stock, it is required to disregard the status of the stockholder of record and to withhold the tax in cases where the status of the actual owner requires withholding.

Monthly List Returns. It has heretofore been the practice of the Treasury Department to require monthly returns of the amounts withheld by (a) banks or collecting agencies receiving coupons and interest orders not accompanied by certificates of owners and (b) by banks and by corporations on payments of interest and

69 T. D. 1974.
70 T. D. 1974.

dividends. This practice will be continued unless and until the Treasury Department rules otherwise.[71]

ANNUAL LIST RETURNS. The law requires an annual return to be made on or before March 1st of each year of the amounts withheld during the preceding calendar year.[72]

DISPOSITION OF OWNERSHIP CERTIFICATES. The ownership certificates received by the withholding agents are filed with the local collector at the time of filing the list returns. Withholding agents filing monthly list returns are required to file the ownership certificates monthly and those filing annual list returns are required to file

71 The monthly list return to be filed by corporations with respect to payment of interest and dividends is known as Form 1012. When the form is used for reporting tax withheld on dividends there should be stamped across the printed declaration at the top of the form, in large letters, "monthy return of income tax withheld from dividend paid to non-resident alien corporations, etc." (T. D. 2388.) The form used by banks and collecting agencies, receiving coupons not accompanied by certificates of the owners, is Form 1044.

72 Act of September 8, 1916, § 9 (b) as amended by Act of October 3, 1917. Heretofore the annual list return of amounts withheld on payments of bond interest and dividends has been made on Form 1013. (Being a summary of the monthly list returns); the annual list return of amounts withheld on salaries, wages and rent, interest or other fixed or determinable annual income has been made on Form 1042; the annual list return of amounts of tax withheld on foreign income by licensed banks or collection agencies on Form 1043a, and the annual list return of amounts withheld by banks or collecting agencies on payments of interest where coupons and interest orders were not accompanied by certificates of owners, on Form 1044a. The use of these forms will be continued, where necessary, until others are prescribed.

such certificates annually, in each case accompanying the return.

PAYMENT OF AMOUNTS WITHHELD AT THE SOURCE. The withholding agent is required to pay to the local collector the amounts withheld at the source, on or before June 15 of the year following the year in which the amounts were withheld. The usual notice of assessment, and notice and demand, is sent to the withholding agent and payment is made in the same manner as payment of the tax.[73]

Penalty for Failure to Withhold the Tax. The statute expressly provides that withholding agents are personally liable for the tax which they are required to withhold at the source.[74] When a withholding agent, through ignorance of his duties, or for any other reason, has failed to withhold the tax and to make return, a return may be filed, upon discovery of his neglect, accompanied by a claim for the abatement of such items of tax as can be shown to have been paid by the taxpayers against whom the tax should have been withheld.[75]

[73] See Chapter 36.

[74] Act of September 8, 1916, § 9 (b) as amended by Act of October 3, 1917.

[75] Mimeograph letter No. 1265 to Collectors.

CHAPTER 42

COVENANTS TO PAY TAXES

Covenants to pay taxes are contained in bonds, mortgages, notes, leases and similar instruments whereby it is stipulated that the interest, rent, or other income payable thereon, shall be paid without deduction for taxes. Many such covenants became operative under the 1913 and 1916 Laws by reason of the requirement in those laws that the normal tax should be withheld at the source. They are operative under the present law only in cases (a) where the payee of the income is a non-resident alien individual, (b) in the case of payments of interest, on the bonds, mortgages or other obligations of corporations, to foreign corporations not engaged in business or trade in the United States and not having an office or place of business therein, and (c) in the case of payments of such interest to citizens and residents, to the extent that one 2% normal tax is required to be withheld.[1]

Since there is a requirement in the law that the tax be withheld on payments to citizens or residents in cases where the interest paid is upon bonds and mortgages, or deeds of trust or other similar obligations of corporations containing a contract or provision by which the obligor agrees to pay any portion of the tax imposed by the law upon the obligee, or to reimburse the obligee

[1] See Chapter 41.

for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, it becomes a matter of importance to officers of corporations to determine whether or not the covenants in the bonds or mortgages of the corporation are broad enough in general language, or specific enough, to require the corporation to assume the burden of the present income tax. Unless there is a legal obligation to pay the income tax, or any part thereof for the bondholder, the officers of the corporation may incur liability by making such payments, since if there is no legal compulsion, the payment of the tax of a bondholder is a diversion of the funds of the corporation to which the stockholders and creditors may object and for which the officers may incur personal liability. An examination of the covenant in each bond or mortgage becomes essential.

A covenant reading as follows does not impose any duty upon a corporation to withhold the tax at the source on payments to citizens or residents:

> "Both principal and interest of this bond are payable without deduction for any taxes, assessments or other governmental charges which the company may be required to pay thereon or authorized to retain therefrom under any present or future law or requirement of the United States of America (except any Federal Income Tax) or any State, county, municipality or other governmental subdivision thereof." [1a]

Many covenants to pay taxes were entered into prior to the enactment of the 1913 Law, and without contemplation of an income tax law requiring collection at

1a Letter from Treasury Department dated November 21, 1917; I. T. S. 1917, ¶ 2511.

the source. In such covenants no specific reference is made to an income tax and the force of the covenant with respect to the present income tax depends upon the general language used therein. One typical form reads as follows:

"Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessment or assessments, or other Governmental charges, which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States. or of any state. county, municipality or other lawful taxing authority thereof."

Whether this form of covenant requires the corporation to pay the income tax of the bondholder, or only such taxes as are imposed on the bond or interest, as such, is an unsettled question. In a recent case decided by the Supreme Court of the State of Arkansas it was held that a clause in bonds issued by a corporation promising payment "without deduction from either such principal or interest, for any tax or taxes, which the Marion Hotel Company may be required to pay or retain therefrom, under any present or future law, the Marion Hotel Company agreeing to pay such tax or taxes," did not require the corporation to pay the Federal income tax of the bondholder which it retained from the payment of interest on the bonds, since the tax is not a tax on the bond, but a personal obligation of the bondholder, arising out of the possession of an income in excess of the exemptions and deductions allowed by such law.[2] The

[2] Urquhart v. Marion Hotel Company, 194 S. W. 1. The court referred to the early cases of Haight v. Railroad Co., 6 Wall. (73 U. S.) 15, 18 L. Ed. 818; Baltimore v. Baltimore R. R., 10 Wall. 543, 19 L. Ed. 1043.

Supreme Court of Massachusetts in deciding whether the income tax came within the terms of a covenant by a lessee to pay "all taxes and assessments * * * upon or in respect of the rent * * * howsoever and to whomsoever assessed," held that the 1913 Law imposed the tax "in respect of the rent" and held that the language quoted was effective to compel the tenant to assume the tax of the landlord to the extent that the law required the amounts thereof to be withheld at the source.[3]

Other covenants provide that the debtor "will pay the principal and interest of these bonds without deduction for taxes." It is a question whether or not covenants of this kind are broad enough to include taxes upon the bondholder as well as taxes assessed against the corporation upon the mortgage or bond or interest. Where a lease provided that the lessee should "pay all taxes and assessments—upon the yearly payments herein agreed to be made by the party of the second part to the party of the first part—for the payment or collection of which taxes or assessments the said party of the first part would otherwise be liable or accountable under any lawful authority whatever;" and that the lessee "should pay all taxes, charges, levies, claims, liens and assessments of any and every kind, which during the continuance of the term hereby demised, shall, in pursuance

[3] Suter v. Jordan Marsh Company, 113 N. E. 580. The court seemed to rest its decision in this case on the conclusion that the tax was levied upon the separate sources from which a part of the net income was derived. This conclusion seems to be contra to the weight of authority that the tax is on the person and not on his property. If such conclusion had been reached by the court it seems from the opinion that the decision might have been different. See, however, Catawissa R. R. Co. v. Phila. & Reading Co., 255 Pa. 269.

of any lawful authority, be assessed or imposed upon the demised premises, or any part thereof—all payments required to be made by the party of the first part during the term of this indenture—shall be assumed and discharged by the party of the second part as if the party of the second part were primarily liable for same," it was held that the lessee was liable for the income tax of the lessor on the ground that it was the apparent intention of the parties that the lessor should receive the amounts stipulated as rent without deduction by reason of any tax, charge or assessment of any kind and that the language was sufficiently broad to cover the Federal income tax although not enacted at the time the lease was made.[4] In another case it was held that where a covenant provided that the specified rent should be paid "without any deduction, defalcation or abatement for any taxes, charges or assessments whatsoever, * * * it being the express agreement of the said parties that the said covenantor, his heirs and assigns, shall pay all taxes whatsoever that shall hereafter be laid, levied or assessed by virtue of any law whatever, as well on the said hereby granted lot and buildings thereon erected or to be erected as on the said yearly rental now charged thereon" it was held that the covenant did not impose an obligation upon the lessee to pay the Federal income tax, but that the parties contemplated a tax measured by accumulated surplus or property.[5] Again, where a lease provided that the lessee should "pay all taxes, charges and assessments * * * imposed under any existing or future law on the demised premises, or any

[4] Northern Pennsylvania R. R. Co. v. Philadelphia & Reading Ry. Co., 43 Pa. C. C. 150; aff'd 249 Pa. 326.

[5] Van Beil v. Brogan, 23 D. R. 1055 (Dauphin County Court, Pa., 1914).

part thereof, or on the business there carried on, or on the gross receipts or net, derived therefrom, or upon the capital stock of 'the lessor' or the dividends thereon, or upon the franchises of the said company, for the payment or collection of any of which said taxes the 'lessor' may otherwise be or become liable'' it was held that the lessee was not required to pay the Federal income tax on the rental received by the lessor on the ground that such tax was not expressly mentioned and the covenant was not broad enough to discharge all liability for taxes of every kind for which the lessor should become primarily liable.[6]

The cases referred to above are cases which have been decided under the 1913 or 1916 Laws. Other cases arising under different statutes are referred to in the foot note.[7]

6 Little Schuylkill etc. Co. v. Philadelphia & Reading Ry. Co., 44 P. A. County Ct. Rep. 197. It seems in this case the intention of the lessor was to have the lessee pay any and all taxes so that the net amount of the rental could be distributed without diminution to the stockholders, but the court held that the language of the covenant was not broad enough to so hold.

7 Northern Trust Co. v. Buck, 263 Ill. 222, 104 N. E. 1114, Pettibone v. Smith, 150 Pa. 118, 24 Atlantic 693; Chicago etc. Ry. v. Kansas City N. W. R. R., 75 Kans. 167, 88 Pac. 1085; Erie, etc., R. R. v. Pennsylvania R. R., 208 Pa. 506, 57 Atlantic 980; Clopton v. Phila. & Reading R. R. Co., 54 Pa. 356; Northern Central R. R. Co. v. Jackson, 7 Wall. 262; U. S. v. Baltimore & Ohio R. R. Co., 17 Wall. 322. See also article in Illinois Law Review, January, 1915.

CHAPTER 43

CONSTITUTIONALITY OF THE LAW

It is not the purpose of this chapter to discuss exhaustively the constitutional questions which might exist with respect to the present laws, but to point out certain features of the law with respect to which questions of constitutionality have been raised.

Power of Congress to Levy Income Taxes. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." As Chief Justice White has said,[1] this amendment does not confer power to levy income taxes in a generic sense or to limit and distinguish between one kind of income tax and another, but the whole purpose was to relieve all income taxes, when imposed, from apportionment; in short, doing away with the principle upon which the Pollock case[2] was decided. The amendment places no limitation as to the nature and character of the income taxes which it authorizes. Congress derives from the Constitution[3] its powers "to lay and collect taxes, duties, imposts and excises." This power is

1 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

2 Pollock v. Farmers Loan and Trust Co., 157 U. S. 429; 158 U. S. 601.

3 The Constitution of the United States, Art. 1, § 8.

exhaustive and embraces every conceivable power of taxation, limited only by the constitutional provisions that "all duties, imposts and excises shall be uniform, throughout the United States,"[4] that "direct taxes shall be apportioned among the several states"[5] and that "no capitation or other direct tax, shall be laid, unless in proportion to the census."[6] The Sixteenth Amendment removed the limitation but did not enlarge the power of Congress.

Taxing Gains and Profits from Sale of Property. The decision in Gray v. Darlington[7] has sometimes been mentioned as placing a limitation on the power of Congress to tax profits arising from the sale of capital assets, on the ground that the word "income" as used in the Sixteenth Amendment was used in the sense in which it had theretofore been defined in this case,[7a] but the case hinged on a consideration of the language of a particular act,[8] and did not define the term in any general sense. The only question before the court was to what extent had Congress intended by that act to tax gains and profits. The court said in part: "The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language, is 'that there be levied, collected, and paid *annually* upon the gains, profits and income of every person,' derived from certain specified sources, a tax of five per cent., and that this tax shall be 'assessed,

[4] Id. Art. 1, § 8, Cl. 1.

[5] Id. Art. 1, § 2, Cl. 3.

[6] Id. Art. 1, § 9, Cl. 4.

[7] Gray v. Darlington, 15 Wall. 63.

[7a] The word must be presumed to have been used in the sense in which the Supreme Court had theretofore defined it if a judicial definition had been clearly given. Towne v. Eisner, 242 Fed. 702.

[8] Act of March 2, 1867.

collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax.'[9] This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. There are exceptions, as already intimated, to the general rule of assessment thus prescribed. One of these exceptions is expressed in the statute, and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased, not only within the preceding year, but within the two previous years. Another exception is implied from the provision of the statute which requires all gains, profits, and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimation of the assessor. The estimation must, therefore, necessarily embrace gains and profits from trade and commerce, and these, for their successful prosecution, often require property to be held over a year. In the estimation of gains of any one year the trader and merchant will, in consequence, often be compelled to include the amount received upon goods sold over their cost which were purchased in a previous year. Indeed, in the estimation of the gains and profits of a trading or commercial business for any one year, the result of many transactions have generally to be taken into account which originated previously. Except, however, in these and similar cases, and in the cases of sales of real property, the statute only applies to such gains, profits, and

9 14 Stat. at Large, 477-8, § 13.

income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected."[10]

The facts in this case were that Darlington, who apparently was neither a merchant nor a trader, exchanged in 1865 certain U. S. Treasury notes for certain U. S. bonds. Two years later the law was enacted, and two years after the incidence of the tax (in 1869) he sold the bonds at a profit. The profit was held by the Treasury Department to be income for the year 1869. The court held: "We are satisfied that no such result was *intended by the statute.*" Since this decision hinged upon the language of the statute its application to the present law necessitates a comparison of the language of the Act of 1867 and the 1916 Law. The Act of 1867 provided for a tax upon the annual gains, profits and income of every person "from any source whatever" and further provided that in estimating the gains and profits and income, profits realized within the year from sales of real estate purchased within the year or within two years previous should be included as well as "all other gains, profits and income derived from any source whatever." The language of the statutes enacted since

10 In the case of Cleveland, C., C. and St. L. Ry. Co. v. United States, 242 Fed. 18, the court said: "The precise point decided in Gray v. Darlington was that the accretion in value during the previous years were not income for the year in which the property was sold; but doubtless some of the language of the opinion would indicate that such accretions were not income even for the year in which they happened." The language to which the court refers, however, seems to be dicta and, in the language of the opinion quoted in the text above, it was intimated that the rule as to merchants and traders would be different from the rule as to persons making isolated investments, this difference being due to the language of the act and not predicated upon any general principles.

the Sixteenth Amendment is much broader. The tax is imposed on "gains, profits and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property" or gains or profits and income derived from any source whatever. In the 1916 Law there is a provision which expressly prescribes the method of computing the gain derived from the sale of assets acquired before March 1, 1913. There seems to be no doubt that Congress intended to tax profits from any and all sales of property, regardless of when the property was acquired, and it does not seem that there is any want of power to do so under the Sixteenth Amendment.[11]

Want of Due Process of Law. The due process clause of the Fifth Amendment to the Federal Constitution is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, the Constitution does not conflict with itself by conferring on the one hand a taxing power and taking the same away on the other by the limitations of the due process clause. To make a tax statute unconstitutional the seeming exercise of the taxing power of the act must be so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion. In Brushaber v. Union Pacific R. R. Co., the Supreme Court, after enumerating a number of features of the 1913 Law which, it had been alleged,

11 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

constituted a violation of the due process clause, dismissed them by stating that none in the remotest degree presented such questions. The expediency of levying a tax, or the economic mistake or wrong involved in its imposition, is beyond judicial cognizance.[11a] In another case the court held that the fact that the tax was levied on the income of mining companies without making adequate allowance for depletion did not amount to the taking of property without due process of law.[12]

Uniformity. The Constitution exacts only a geographical uniformity of taxes and a lack of uniformity in other respects does not make the statute invalid.[13]

Exempting Certain Corporations from Tax. The provision of the Sixteenth Amendment authorizing a tax on incomes "from whatever source derived" does not require that the tax must be imposed upon all sources of income, nor does it exclude the power to exempt certain classes of corporations.[14]

Retroactive Features. The right of Congress to impose a tax by a new statute, although the measure of the tax is governed by the income of the past year cannot be doubted; much less can it be doubted that Congress may impose a tax on income of the current year, though part of that year has elapsed when the

11a Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

12 Stanton v. Baltic Mining Co., 240 U. S. 103.

13 Knowlton v. Moore, 178 U. S. 41; Patton v. Brady, 184 U. S. 608; Flint v. Stone-Tracy Co., 220 U. S. 107; Billings v. United States, 232 U. S. 261; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

14 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

statute is passed.[15] A statute imposing a tax upon all income of a previous year, although one tax on that income has already been paid, is valid.[16]

15 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.
16 Stockdale v. Insurance Companies, 20 Wall. 323.

CHAPTER 44

TAX ON UNDISTRIBUTED INCOME OF CORPORATIONS

The provisions imposing this tax are contained in and are a part of the 1916 Law as amended.[1] The tax has been sometimes referred to as a "supertax on corporations." The purpose of the tax is to counteract the tendency of corporations to permit their earnings to accumulate as surplus, which action, although not taken with the intent of evading the supertaxes, would, nevertheless, operate to reduce the supertaxes paid by individual stockholders. Under this provision of the law a corporation may retain any part or all of its earnings for the year, provided it is willing to pay a tax of 10% upon such portion thereof as is not actually invested and employed in the business, retained for employment in the reasonable requirements of the business, or invested in obligations of the United States issued after September 1, 1917. Of course, if the earnings of the corporation are accumulated with a fraudulent purpose or intent of preventing the imposition of the supertaxes on the stockholders, such stockholders will be taxed as though the earnings had been distributed.[2] The provision imposing this tax is not intended to take the place of the provision contained in Section 3 of the 1916 Law, but is

[1] Act of September 8, 1916, § 10 (b), added by Act of October 3, 1917.

[2] See Chapter 2.

intended to operate in cases where the annual net income is retained beyond the reasonable requirements of the business of the corporation and yet not with fraudulent intent to avoid the imposition of the supertaxes on the stockholders of the corporation.

Corporations Subject to the Tax. The law provides that the tax shall apply to "every corporation, joint-stock company or association or insurance company." This language, however, can hardly be construed to mean every corporation which derives any income from sources within the United States, since such income is derived by foreign corporations over which this Government would not have sufficient jurisdiction to impose a tax of this character. The tax, undoubtedly, applies to every domestic corporation and to such foreign corporations as have their principal office or place of business in the United States, that is, the class of corporations, somewhat indefinitely referred to in the 1916 Law as "resident corporations." The line between foreign corporations which are, and those which are not, subject to this tax might be drawn with reference to the taxability of the non-resident alien stockholders of the corporation on dividends received from the corporation. Thus, if the Government has no jurisdiction to tax the stockholders on their dividends its would seem to have no jurisdiction to impose this tax on the undistributed income of the corporation.

Undistributed Net Income. The undistributed net income referred to in this provision of the law is the income for the taxable year, either the calendar year or the fiscal year as the case may be. The first year for which the tax is imposed is the calendar year 1917 or, if

the corporation has elected to report its net income for the fiscal year, the fiscal year ending in 1917; in the latter case, however, the tax applies only to the proportion of the taxable undistributed net income for such fiscal year as the period between January 1, 1917, and the end of the fiscal year bears to the whole of such fiscal year. For example, if the fiscal year of a corporation ends on the 30th day of June, 1917, and its taxable undistributed income for that fiscal year is $50,000 only one half thereof or $25,000 will be taxable, since only one half of the fiscal year is in the calendar year 1917. This provision of the law has no reference to the income, profits or surplus earned or accumulated by the corporation prior to January 1, 1917, whether or not such income, profits or surplus is employed in the business. The fact that surplus accumulated prior to January 1, 1917, may not be employed in the business or retained for the reasonable requirements of the business, may, however, have a bearing upon the taxability of the income for the current year, since it would be difficult to earmark the current income and employ it in business while surplus previously accrued is not so employed. Within the meaning of this provision of the law, the net income for the current year is distributed only when paid to the stockholders as dividends. Another provision of the law, respecting dividends,[3] deems such dividends to have been paid out of the most recently accumulated undivided profits or surplus. Hence, any dividends declared within six months after the close of a calendar year or fiscal year may be considered as a distribution of the income of such preceding year, unless the books of a

[3] Act of September 8, 1916, § 31 (b), added by Act of October 3, 1917.

corporation have been closed within the six months and earnings of the current year have been credited to surplus or undivided profits. The difference between the amount of net income reported by the corporation in its return of annual net income and the amount thereof distributed by the corporation at any time before the expiration of six months after the end of its fiscal or calendar year, constitutes the undistributed net income which this provision of the law seeks to tax. From such amount of undistributed net income may be deducted (a) the amount of any income taxes paid by the corporation within the taxable year imposed by authority of the United States; (b) that portion of such undistributed net income which is actually invested and employed in the business or; (c) is retained for employment in the reasonable requirements of the business, or (d) is invested in obligations of the United States issued after September 1st, 1917.[4]

INCOME TAXES PAID WITHIN THE YEAR. For the purpose of determining the net income subject to the income tax a corporation is not permitted to deduct the amount of the Federal income taxes paid within the year, but such amounts may be deducted for the purpose of this tax. Excess profits taxes paid during the year are not deductible for the purpose of this tax since the net income subject to this tax is the same as that determined for the purpose of the tax imposed by Subdivision 10a of the 1916 Law, which is the income remaining after the Commissioner of Internal Revenue has deducted the amount of excess profits taxes assessed against the cor-

[4] Act of September 8, 1916, § 10 (b) added by Act of October 3, 1917.

poration in the same year. As an illustration, if a corporation has a net income of $100,000 for the year 1917 and the war excess profits tax assessed against it, on such income, is $20,000, the income tax for 1917 will be assessed upon the remainder of the net income after deducting the amount of $20,000, that is, on $80,000. From the sum of $80,000 the corporation may further deduct the amount of Federal income taxes assessed against it for the year 1916, and paid by it in the year 1917, (not the income tax assessed against it for the year 1917, since such tax is not paid until the year 1918). From the net amount so obtained, it may deduct the amount of undistributed net income employed or invested as indicated in the three following paragraphs.

NET INCOME ACTUALLY INVESTED AND EMPLOYED IN THE BUSINESS. The amount of undistributed net income for the taxable year which is actually invested or employed in the business is not taxable. Under this head should be included only such earnings as have been actually and permanently invested or employed within the taxable year or within six months after the end of such year.

NET INCOME RETAINED FOR EMPLOYMENT IN THE REASONABLE REQUIREMENTS OF THE BUSINESS. This deduction differs materially from the one referred to in the preceding paragraph. It is not required that the undistributed net income shall be actually used or employed in the business before the expiration of six months after the end of the taxable year, but it is sufficient if such income has been retained for employment in the reasonable requirements of the business. The "reasonable requirements of the business" will be for

practical purposes what the Treasury Department construes the phrase to mean. It is not unlikely that the term will be given a very narrow construction in the first and general rulings, leaving a more liberal construction to be worked out as specific instances are ruled upon. It seems that even under the strictest construction an amount retained for employment in the business during the following year is reasonable, so long as it is not in excess of such percentage of the earnings as the officers of the corporation have found by experience in previous years to be necessary to take care of the normal growth and expansion of the business. Sums which may be retained for the purpose of making up losses in "lean" years will probably be held not to be "reasonable" since the advent of a lean year is a contingency which cannot be anticipated with any reasonable certainty. Amounts retained for the purpose of equalizing dividends in the future would seem to be retained rather as a matter of advisability or expediency, than for the reasonable requirements of the business. Income retained by a corporation for the purpose of meeting any definite obligation coming due at a certain time in the future is retained for the reasonable requirements of the business. Amounts set aside in sinking funds to pay off mortgages would come within this class, unless the amount set aside in any year is clearly much greater than reasonably necessary, considering the amount of the mortgage debt, the amount previously set aside in the sinking fund, and the length of time to elapse before the due date of the mortgage. The earnings of a corporation used to purchase preferred stock for cancellation are held to be retained for employment in the reasonable requirements of the business and therefore not taxable.[5]

[5] T. D. 2570.

NET INCOME INVESTED IN OBLIGATIONS OF THE UNITED STATES. In order to avoid any question as to whether or not the undistributed net income for the year has been retained for the reasonable requirements of the business, such income may be invested in obligations of the United States issued after September 1, 1917. Any amount so invested may be deducted, for the purpose of this tax, whether or not it is necessary, or merely advisable, to retain such amount for employment in the business at some future time. Such part of the net income for the current year as may be invested in the first issue of Liberty Loan bonds will be subject to the tax unless, by such investment, the amount is employed in the business or the amount is retained for employment in the reasonable requirements of the business.[6] The exemption as to investment in obligations of the United States applies only to such obligations as are issued after September 1, 1917.

Rate of Tax. On the amount of net income remaining undistributed six months after the end of each calendar or fiscal year, after deducting the several deductions described above, a tax of 10% is levied. The law does not contain any provision as to when the tax is due and payable or to whom it shall be paid. Such administrative details are left to be covered by regulations.[7]

[6] T. D. 2570.

[7] As first proposed this provision of the law gave only a period of two months in which to distribute the earnings for the preceding calendar or fiscal year, and it was apparently the intention of Congress that the amount remaining undistributed should be reported upon the form of return of annual net income, and that the tax should be paid at the same time and in the same manner as the income tax. The present period of six months in which to

Penalty Tax. If a corporation has reported its net income for a calendar or fiscal year as being employed in the business, and the Secretary of the Treasury ascertains and finds that any portion of such amount is not so employed, or, if the corporation has reported an amount to be retained for employment in the reasonable requirements of the business, and the Secretary of the Treasury ascertains that the amount is not reasonably required in the business, a tax at the rate of 15%, instead of 10%, is imposed upon such amount. It should be noted that this provision practically makes the Secretary of the Treasury judge as to when the earnings are employed in the business, or what the reasonable requirements of the business may be. The provision is intended as a means of deterring officers of corporations from making too liberal allowances for the reasonable requirements of the business. In effect, the provision imposes a penalty of 50% of the amount of the tax for understatement of the taxable undistributed earnings.

Returns. The law does not indicate when or with whom the returns on which this tax is to be assessed should be filed. The matter is left entirely to the Treasury Department, which has issued no regulations at the time of this writing.

make distribution of the earnings eliminates this method of reporting and paying the tax.

CHAPTER 45

THE WAR EXCESS PROFITS TAX

This momentous tax measure [1] was framed by a Conference Committee composed of members of the House and the Senate, in the last days of the First Session of the 65th Congress, under stress and in a hurry. It bears many evidences of hurried workmanship, and lack of careful consideration of the effect, one upon the other, of the many uncorrelated provisions.[2] In the early days of the session the House of Representatives introduced a measure proposing to raise the rate of the then-existing excess profits tax. This was succeeded by a proposal of the Senate Finance Committee to make the measure a war profits tax, that is, a tax on the excess of profits for the current year over the average profits for the pre-war period. The final result was a compromise between the adherents of the two proposals,

[1] Act of October 3, 1917 (Public No. 50), 65th Congress, Title II, §§ 200 to 214, inclusive.

[2] This chapter is written before any indication has been given by the Treasury Department of its construction of the law. No attempt is made to foreshadow the rulings which will be issued. In the opinion of the author, the law is so defective that extensive amendment will be necessary before it can be applied to the purpose for which it was drafted. Many indications lead to the conclusion that pressure will be brought to bear on Congress to amend the law as soon as possible, and perhaps before any tax is assessed under the present statute.

and the present tax is neither a tax on excess profits nor a tax on war profits, but a tax partaking of the characteristics of both. The tax is imposed on income over a fixed minimum exemption and a deduction of varying percentages of the invested capital. The taxability of a business concern existing during the prewar period is affected, but only slightly, by the rate of its earnings on invested capital during that period. The taxpayers under this statute are divided into four classes, special provisions applying to each class. These classes are (a) domestic corporations and partnerships, (b) individuals, citizens of or residing in the United States, (c) foreign corporations and partnerships and (d) non-resident alien individuals. The tax is imposed upon the entire net income of every corporation and partnership and upon the net income of every individual derived from business, trade, profession or occupation. The individual investor, it seems, who is not engaged in any business, trade, profession or occupation, is not intended to be taxed, but the individual deriving an income from a salary is within the purview of the law. For the purpose of the discussion in this chapter, a general statement of how the tax is imposed, or what might be called a formula, is given in the following paragraph, the terms and phrases used therein being defined in succeeding paragraphs.

General Statement. The tax is imposed on the amount of net income [3] from any trade or business [4] for the taxable year [5] after deducting (a) an amount not

[3] See Definition on pp. 509 to 512.

[4] See Definition on p. 508.

[5] See Definition on p. 507.

less than 7% nor more than 9% [6] of the invested capital [7] and (b) the specific exemption allowed by the law,[8] at graduated rates [9] unless no invested capital or not more than a nominal capital [10] is employed, in which case the tax is 8% of the net income of such trade or business in excess of the specific exemption allowed by law. The tax will be assessed on information given by the taxpayer in his or its return of annual net income, (partnerships being required to file returns for this purpose) and will be due and payable at the same time as the income tax.

Corporation. The term "corporation" includes joint stock companies or associations, and insurance companies.[11] A domestic corporation is one created under the laws of the United States or of any state, territory or district thereof. A foreign corporation is one created under the laws of Porto Rico, the Philippines, the Panama Canal Zone, Virgin Islands or the laws of any other possession of the United States or the laws of any foreign country or Government.[12] Corporations exempt from the income tax are also exempt from this tax.[13] A foreign corporation deriving less than $3,000 of net income from sources within the United States during a taxable year is not required to pay any tax.[14]

6 See p. 527.

7 See Definition on pp. 512 to 526.

8 See Definition on p. 529.

9 See Definition on p. 530.

10 See Definition on p. 526.

11 The term, as used in this law, has the same meaning as in the income tax law. For a discussion of the definition under that law see Chapter 12.

12 Section 200.

13 Section 201, see Chapter 15.

14 Section 202.

Partnerships. The law does not define the term "partnerships," but the intent is, undoubtedly, to include all kinds of partnerships, general and limited. Limited partnerships have been held by the Treasury Department to come within the definition of the term "corporations."[15] A domestic partnership is one created under the law of the United States, or of any state, territory or district thereof. A foreign partnership is one created under the law of any other possession of the United States or of any foreign country or government.[16] Partnerships carrying on or doing the same business, or coming within the same description, as corporations exempt from the income tax law, are exempt from this tax.[17] A foreign partnership deriving less than $3,000 of net income from sources within the United States during a taxable year is not required to file a return or pay any tax.[18]

Individuals. Special provisions apply to individuals who are citizens and residents of this country. The definition of the term "citizens and residents" will undoubtedly be the same as that made with respect to the income tax law,[19] except that the term "United States" as defined in this statute does not include Porto Rico, the Philippines or other possessions. It would seem that Congress did not intend the tax to apply to the incomes of the citizens and residents of those possessions, except to the extent that such income is derived from business or trade conducted within the "United States,"

15 See Chapter 12.
16 See Section 200.
17 Section 201; see Chapter 15.
18 Section 202.
19 See Chapter 4.

as the term is defined in the following paragraph. The term "non-resident alien individuals" is not defined in the statute but the definition of the Treasury Department, under the income tax law, will probably be applied to the term as used in this statute.[20] Individuals carrying on or doing the same business, or coming within the same description, as corporations exempt from the income tax, are exempt from this tax. Officers and employees of the United States, or any state, territory or the District of Columbia, or any local subdivision thereof, are exempt with respect to the compensation or fees received by them as such officers or employees.[21] A non-resident alien deriving less than $3,000 of net income from sources within the United States during a taxable year is not required to pay any tax under this law.[22]

United States. The term "United States" means only the states, the territories of Alaska and Hawaii, and the District of Columbia.[23] In view of this definition a foreign corporation, or partnership, or a non-resident alien, deriving income from Porto Rico, Philippines, Virgin Islands, Panama Canal Zone and other possessions will not be subject to this tax.

Taxable Year. In the case of individuals, the term "taxable year" means the calendar year, the first taxable year being the year 1917. In the case of corporations and partnerships, the term means the calendar year, unless the corporation or partnership has fixed its own fiscal year, in which case it means such fiscal year.

20 See Chapter 5.
21 Section 201.
22 Section 202
23 Section 200.

Where a fiscal year has been fixed, the first taxable year is the fiscal year ending in 1917. In such cases, the tax for such fiscal year will be that proportion of the tax computed upon the net income for the full fiscal year which the time in 1917 bears to the full fiscal year.[24] The tax will be computed upon the full income for the fiscal year, but only such part thereof will be assessed as is ascertained by multiplying the amount computed for the full fiscal year by the fraction of the fiscal year falling in the calendar year 1917. For example, if one-third of the fiscal year falls in the calendar year 1917, one-third of the full amount of the tax so computed will be assessed.

Prewar Period. The term "prewar period" means the calendar years 1911, 1912 and 1913. If a corporation or partnership was not in existence during the whole of such period, its "prewar period" will be as many of such years during the whole of which it was in existence. If an individual was not engaged in trade or business during the whole of such period, his "prewar period" will be as many of such years during the whole of which he was engaged in the trade or business.[25] The purpose of fixing a prewar period is solely to determine what particular percentage of invested capital between 7% and 9% may be taken by the taxpayer as a deduction.[26]

Trade and Business. The term "trade and business" is defined in the law to include professions and occupations.[27] The term has no particular value with reference to corporations and partnerships, since every corporation

[24] Section 200.
[25] Section 200.
[26] Section 203.
[27] Section 200.

and partnership is deemed to be engaged in business and all of its income is deemed to be the income of a single trade or business.[28] In other words, the tax is not imposed with respect to income from the trade or business of a corporation or partnership, but with respect to its entire net income from all taxable sources. With respect to individuals, the Treasury Department has already defined the term "trade or business" under the income tax law.[29] The term has been given a very narrow construction under the income tax law, and it has been held that one deriving income from the purchase and sale of securities is not engaged in business, unless he is a member of an exchange. This ruling was made with reference to deducting losses incurred in trade, and it was naturally to the interest of the Government to give a very narrow definition to the term "in trade." It is not at all unlikely that under the present law the same term will be given a broader definition, since the interests of the Government are now served by including as many activities as possible within the term, and the present statute expressly defines the term to include "all trades or businesses of whatever description, whether continuously carried on or not," including "professions and occupations."[30] Income derived from the business of life, health, and accident insurance combined in one policy issued on the weekly premium payment plan is exempt from the tax.[31]

Net Income of Domestic Corporations. The net income of a domestic corporation, to which this tax applies,

28 Section 201.

29 See Chapter 4, p. 32.

30 Section 200 and section 201.

31 Section 201.

is the income of the taxable year as reported in the return of net income, except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the income tax are deducted.[32] It is to be noted that the net income is ascertained by excluding income defined to be exempt under the income tax law, and further, by excluding dividends received from corporations subject to the income tax. It is also to be noted that such dividends may be deducted if the corporation is subject to the *income tax,* although it may not be subject to this excess profits tax. Dividends received from corporations, not subject to the income tax, may not be deducted.

NET INCOME FOR PREWAR PERIOD. The net income of a domestic corporation for the year 1911 is to be determined according to the provisions of the 1909 Law (excluding dividends) except that the amount of the tax assessed by the Federal Government on the income of the corporation for the year 1910 (and paid by the corporation in 1911) should not be deducted.[33] Corporations were permitted to deduct such amounts in ascertaining their net income under the 1909 Law, but in ascertaining the net income of the prewar period, for the purpose of this tax, the amount need not be deducted. It is, of course, a slight advantage to the corporation to include the amount of such taxes, in order to increase the amount of income for the prewar period. The net

32 Section 206.

33 The language of the statute is "except that *income* taxes paid by it within the year imposed by the authority of the United States shall be included." The tax imposed by the 1909 Law was not an income tax but an excise tax but Congress undoubtedly had reference to that tax in using the language quoted.

income for 1912 is ascertained in the same manner as indicated above for 1911, except that the tax imposed by the Federal Government upon the net income of the corporation for the year 1911 (and paid by the corporation in 1912) should be included. The net income for the year 1913 is ascertained in the manner provided by the 1913 Law, except that the tax assessed under the 1909 Law on income for 1912 (and paid in 1913) should be included, and the amount received by the corporation as dividends upon the stock of other corporations taxable under the 1913 Law should be deducted. [34]

Net Income of Foreign Corporations. The net income of a foreign corporation is the net income received from sources within the United States,[35] as reported for the purpose of the income tax, but not including the income received from dividends of domestic or resident corporations subject to the income tax. It follows from this that in so far as a foreign corporation receives dividends from this country it is not subject to the tax imposed by this law.

NET INCOME FOR PREWAR PERIOD. The income of a foreign corporation for the prewar period is ascertained in the same manner as indicated above in the case of domestic corporations, except that it will include only net income received during that period from sources within the United States. [36]

Net Income of Partnerships. The net income of domestic partnerships is determined in the same manner

[34] Section 206.

[35] Section 200 and section 206. See Definition of United States, supra.

[36] Id.

as in the case of citizens and residents of this country, and the net income of foreign partnerships is determined in the same manner as in the case of non-resident aliens.

Net Income of Individuals. The net income of individuals (and of partnerships) is ascertained for the years of the prewar period, and for the taxable year, upon the same basis and in the same manner as provided in the 1916 Law, as amended, except that dividends received from a corporation taxable upon its net income may be deducted. It is to be noted that returns of net income filed for the year 1913 do not disclose the net income required to be reported under this law, since the 1913 Law differed in many respects from the 1916 Law. The net income of citizens and residents and the net income of non-resident aliens will be ascertained, respectively, by following the provisions applicable to each class. The law is not clear as to whether or not an individual engaged in two or more businesses should report separately the income from each business, or even if, by reason of being engaged in business, he must report all his income from every source, except dividends.[37]

Invested Capital. Invested capital as used in the law, is what the law defines it to be, and not what is generally understood by the term. It does not mean the assets of a business or trade or the book value of a plant. Generally speaking, it means the amount which has been contributed by the stockholders of a corporation, the members of a partnership, or the individual engaged in business on his own account, to the business, either directly, or by permitting the earnings of the corporation, partnership or business to be kept in the business. Money or

[37] See § 206, second paragraph, § 201, first paragraph.

property borrowed is not "invested capital." Further, capital which may have been contributed to the business loses the status of "invested capital" by being invested in stocks (the dividends of which are not included in net income) or by being invested in state, municipal or other bonds of that character (the interest on which is exempt under the income tax law) or other assets, the income from which is not subject to the tax. An exception is made in the case of capital invested in the obligations of the United States. Such capital does not lose its status as "invested capital" although the interest from the bonds may be excluded from net income.[38] The intent of the law seems to be that if capital is invested in an asset the income from which, if any, would not be included as net income, the capital so invested shall not be included as "invested capital" for the purpose of ascertaining the amount of deduction. Thus, if capital is invested in stocks, bonds or other assets the income from which would not be taxable, the capital invested in such assets must be excluded, whether or not any income is actually derived from the assets in question.[39] The purpose of ascertaining the "invested capital" of a business is to allow what Congress considered a fair return or earning thereon before imposing the tax, hence, it follows that if the earnings are not taxable the asset is not "invested capital."

Average Invested Capital for the Year. Since, as indicated in the preceding paragraph, the amount of in-

[38] The purpose of this exception is, of course, to stimulate investment in bonds and certificates of indebtedness issued by the United States for the purpose of raising money to defray the cost of the war.

[39] Section 207.

vested capital may vary from time to time, depending upon the kind or character of asset in which the capital of the business may be invested, and for other reasons, as will appear more fully in the following paragraphs, the law provides that the invested capital shall not be determined as of any particular day in the year, but shall be "averaged monthly." The intent of this provision would seem to be that the amount of invested capital shall be ascertained on some particular day of each month, in order to obtain the average for the year.

Business Carried on by Successor. If a trade or business carried on by a corporation, partnership, or individual, has been organized or reorganized on or after January 2, 1913, the new business concern being substantially a continuation of the trade or business carried on prior to that date, the successor is deemed to have been in existence prior to that date, and the net income and invested capital of its predecessor prior to that date is deemed to have been its net income and invested capital for the prewar period prior to that date.[40] If a reorganization, consolidation, or change of ownership of a trade or business takes place after March 3, 1917, no assets transferred or received from the prior trade or business shall be allowed a greater value than would have been allowed in computing the invested capital of the predecessor (a) if an interest or control in such trade or business of 50% or more remains in control of the same persons, corporations, associations, partnerships, or any of them, (b) unless such asset was paid for specifically as such, in cash or tangible property, and then not to exceed the actual cash or actual cash value of the tang-

[40] Section 204.

ible property paid therefor at the time of such payment.[41]

Invested Capital of Corporations and Partnerships. Subject to the limitations discussed in the three preceding paragraphs, the law provides a particular method for determining the invested capital of a corporation or partnership, which will be discussed in the following paragraphs. Briefly, the invested capital in such cases, consists of (a) the actual cash paid in, (b) the actual cash value of tangible property paid in, (c) subject to certain limitations, the actual cash value of patents and copyrights paid in for stock or shares, (d) subject to certain limitations, the actual cash value of good-will, trade-marks, trade-brands, the franchise of a corporation or partnership or other intangible property paid in for stock or shares issued prior to March 3, 1917, and (e) paid in or earned surplus and undivided profits used and employed in the business.[42]

ACTUAL CASH PAID IN. This means the actual amount of money paid in by shareholders or members for stock or shares. It should be noted that the actual cash paid in is to be taken, not the par value of the stock which may have been issued therefor. If more than par was paid for stock the entire amount so paid may be treated as actual cash paid in, or an amount equal to the par value of the stock may be treated as actual cash paid in and the excess as "paid in surplus," but the same amount should not be included under both heads. It seems that under this head should be included not only cash but the "equivalent of cash," that is, if stock

41 Section 208.
42 Section 207a.

of the taxable corporation has been issued for securities which had an ascertainable value at the time, such securities should be treated as the "equivalent of cash" and the value at the time of issue taken to be actual cash paid in.[43]

TANGIBLE PROPERTY PAID IN. Where tangible property (other than cash) has been paid in by stockholders or members, for stock or shares, the actual cash value of such tangible property, at the time of such payment, may be included as "invested capital" (but in case such tangible property was paid in prior to January 1, 1914, the actual cash value of such property as of January 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor). The phrase "tangible property" as used in this section must be given a liberal construction in order not to work undue hardship on taxpayers. It will include, of course, all property which is "tangible" and should in addition include mining rights, oil leases, and similar species of property, in cases where the consideration for such property was paid in a specific sum by the one contributing it to the corporation or partnership, and is not merely in the form of annual rentals or royalties. The value of tangible property must be taken as of the time it was paid in to the corporation or partnership in exchange for stock or shares, except in cases where it was so paid in prior to January 1, 1914, in which case the value on January 1, 1914 shall be taken. In this connection, the law provides that the value as of January 1, 1914, shall in no case exceed the par value of the original

[43] This seems to be necessary if any credit is to be given for property so acquired.

stock or shares specifically issued for the property. It is not conceivable that Congress intended what the law literally says, as, for instance, there are many cases in which corporations have issued merely nominal amounts of stock in exchange for property of great value, and to hold that the "invested capital" in such cases cannot exceed the par value of the stock would be so unreasonable and unjust as to raise doubts of the constitutionality of the law. Where property of greater value than the stock issued therefor has been transferred to a corporation prior to January 1, 1914, an amount equal to the par value of the stock should be treated as capital, and the excess as "paid in surplus."

PATENTS AND COPYRIGHTS. Patents and copyrights are a species of intangible property which may be considered, when issued for stock or shares, in ascertaining "invested capital." The actual cash value of such patents and copyrights, at the time they were paid in for the stock or shares, may be included as "invested capital," but not to exceed the par value of the stock or shares issued therefor. It seems that the actual cash value at the time patents and copyrights are paid in determines the amount of invested capital, regardless of whether or not the time is before or after the enactment of the law.

GOOD-WILL. Good-will may be considered subject to the limitations, and under the conditions, discussed in a following paragraph entitled "Intangible Property."

TRADE-MARKS. Trade-marks may be considered subject to the limitations, and under the conditions, discussed in a following paragraph entitled "Intangible Property."

TRADE-BRANDS. Trade-brands may be considered subject to the limitations, and under the conditions, discussed in a following paragraph entitled "Intangible Property."

FRANCHISE OF A CORPORATION OR PARTNERSHIP. The franchise of a corporation or partnership may be considered subject to the limitations, and under the conditions, discussed in the following paragraph entitled "Intangible Property."

INTANGIBLE PROPERTY. The law provides that good-will, trade-marks, trade-brands, the franchise of a corporation or partnership, or other intangible property, may be included as invested capital if the corporation or partnership made payment in good faith therefor, specifically as such, in cash or tangible property. This is one of the many obscure provisions of the law and it is difficult to understand the reason for inserting the language, since, if payment is made for such intangible property with cash or tangible property, it must either be cash or tangible property contributed by the stockholders or members, or cash or tangible property borrowed. In the former case the consideration has already been included as invested capital and in the latter case the law expressly provides that borrowed money or property cannot be so included. The law further permits such intangible property to be considered in ascertaining invested capital, when paid for in stock or shares of the corporation or partnership, under the following conditions and limitations: (a) the intangible property must have been purchased in good faith prior to March 3, 1917, and the stock or shares in payment thereof must have been issued prior to March 3, 1917, (b) the amount

of shares which may be considered as having been issued for such intangible property is an amount not to exceed (on March 3, 1917) 20% of the total interests or shares of the partnership or corporation, (c) the amount which may be included as invested capital is the actual cash value of such intangible property at the time of such purchase limited, however, in case of issue of stock therefor to an amount not to exceed the par value of such stock. It will be noted from (a) above that good-will, trade-marks, trade-brands, franchise of a corporation or partnership, or other intangible property paid in for stock or shares may not be considered in determining invested capital if such property was paid in on or after March 3, 1917. The permission applies only to transactions which took place prior to that date. It should also be noted that if the property was paid in prior to that date, but stock or shares were not issued until on or after that date, the transaction cannot be considered, if the law is to be literally construed. The provision stated in (b) above, apparently means that if a corporation or partnership issued more than one-fifth of its' stock or shares for such intangible property, the invested capital may be computed only on such proportion as is represented by one-fifth of the stock or shares. If, for instance, a corporation had, on March 3, 1917, two-fifths of its stock issued for such intangible property, only one-half of the actual cash value (at the time it was paid in) of such intangible property can be considered as "invested capital." The statement under (c) above, indicates that in this case, as in all others, the value of the property, for which shares or stock have been issued, must be taken as of the time the property was acquired, and the stock issued therefor, and, further, that in the case of corporations such value cannot exceed the par

value of the stock issued therefor. The law makes no provision for cases where the contributor may have paid large sums of money for intangible property, such as rights, franchises and good-will. As an illustration, an individual may have purchased a trade-mark, paying therefor the sum of $100,000. If he thereafter forms a corporation and transfers the trade-mark to it, in exchange for $100,000 of stock, the corporation may not, under the language of the law, claim any amount as invested capital with respect thereto. On the other hand, if the same individual had, prior to March 3, 1917, transferred the same trade-mark or trade-brand to a small corporation, merely as a matter of convenience, in exchange for the issue to him of $1,000 of capital stock, the corporation would not be permitted to claim more than $1,000 as invested capital. If the individual uses the trade-mark in his business, without incorporating the business, or taking in a partner, he may claim $100,000 as invested capital. Examples of this sort can be multiplied indefinitely to show the imperfections of the statute.

Surplus and Undivided Profits. In addition to the cash and property paid in by the stockholders or members, a corporation or partnership may include the amount of "paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year."[44] Surplus and undivided profits may be included as "invested capital," if paid in by the stockholders or members, that is, contributed in cash or tangible property, for which no stock or shares have been issued. It seems, for instance, that if tangible property has been "paid in" to a corporation, having an actual cash value at the

[44] Section 207a.

time of such payment greatly in excess of the stock issued for it, an amount equal to the par value of the stock will be considered as capital paid in, and the excess as surplus paid in. Earned surplus is that part of the surplus which has been accumulated by retaining in the business a part of the earnings of any year. The amount of such surplus is a question of fact to be determined in each particular case. The amount of earned surplus of any year since January 1, 1909, will probably be held to be the amount of net income, shown by the return of net income of the corporation, which has not been distributed in the form of dividends to the stockholders. If in any of those years amounts have been charged to expense, which should have been charged to capital, the corporation may perhaps be permitted to reopen its books, make the proper entries and file amended returns. With respect to the years prior to January 1, 1909, it seems that amounts which should actually have been charged to capital may be considered as earned surplus employed in the business, provided proof of that fact can be produced.

USED OR EMPLOYED IN THE BUSINESS. Surplus and undivided profits must be used or employed in the business in order to be considered as invested capital. Since the law expressly provides that a corporation or partnership shall be deemed to be engaged in business, and all trades and businesses in which it is engaged shall be treated as a single business, and all its income from whatever sources derived shall be deemed to be received from such trade or business,[45] it would seem to follow that if surplus and undivided profits are invested in any way to produce "net income" within the meaning of this law, such surplus and undivided profits are used and

[45] Section 201.

employed in the business. For example, if the surplus and undivided profits are invested in obligations of the United States, or bonds (other than state, municipal or other bonds, the interest of which is not included in "net income") it should be considered as employed in the business. The criterion seems to be that if income from the asset in which the surplus or undivided profits are invested would be included in the return for the purpose of this tax, the surplus and undivided profits are "used and employed in the business," whether or not any income is actually derived from the asset. The difficulty which arises is to earmark the capital, surplus, undivided profits and borrowed money of a corporation in order to determine whether or not it is the surplus or borrowed money which might be employed in assets that cannot be included as "invested capital." For instance, a corporation may have a capital stock of $100,000, surplus and undivided profits of $100,000 and a bond issue of $100,000. Its assets may consist of property and plant which cost it $100,000, taxable bonds which cost it $100,000 and stock which cost it $100,000. It cannot be said that either the capital, surplus or borrowed money is invested in any one of these forms of assets. The courts have held that capital or surplus cannot be earmarked, and each form of asset contains, in equal proportions, the capital, surplus and borrowed money of the corporation. Therefore, it would seem that only two-thirds of the surplus is used or employed in the business of the corporation and one-third of the capital is invested in the stock. Hence, only two-thirds, or $133,333, of the capital and surplus is "invested capital." If, on the other hand, the borrowed money was used originally for the purchase of the stock, and it is held by the Treasury Department that the fund can be earmarked, the cor-

poration will be entitled to a deduction on $200,000, since then its capital and surplus will be invested in plant and taxable bonds. The law gives no indication of the manner in which to meet such practical difficulties as this, and the matter is one largely within the discretion of the Treasury Department.

UNDIVIDED PROFITS EARNED DURING THE TAXABLE YEAR. The law expressly provides that surplus and undivided profits shall not include "undivided profits earned during the taxable year," but it seems that surplus earned during the taxable year may be so included, that is, if a part of the earnings for the year is definitely set aside as surplus, and not merely accumulated for the purpose of distribution at the end of the year, such amount should be included as "invested capital," provided it is used or employed in the business.

Invested Capital of Foreign Corporations and Partnerships. The law provides that in the case of a foreign corporation or partnership its "entire invested capital" shall be ascertained in the manner indicated in the preceding paragraphs. That proportion of the entire invested capital which the net income from sources within the United States bears to the entire net income of the foreign corporation or partnership may be taken as the "invested capital" on which to base the deduction under this law.[46]

Invested Capital in the Case of Individuals. Subject to the limitations discussed in the paragraph on "invested capital" and the two paragraphs following it[47] the law provides a particular method for determining the

[46] Section 207, last paragraph.
[47] See pp. 512-515.

invested capital in the case of an individual, which will be discussed in the following paragraphs. Briefly, the invested capital in such cases, consists of (a) the actual cash paid into the trade or business, (b) the actual cash value of tangible property paid into the trade or business, (c) the actual cash value of patents, copyrights, good-will, trade-marks, trade-brands, franchises, or other intangible property, paid into the trade or business, at the time of such payment, if payment was made therefor, specifically as such, in cash or tangible property, not to exceed the actual cash or actual cash value of the tangible property *bona fide* paid therefor at the time of such payment.

ACTUAL CASH PAID INTO THE TRADE OR BUSINESS. This would seem to include any amount of cash used or employed by the individual in the trade or business with respect to which the income is taxed. Where an individual uses in his business large sums of his money at various times of the year, and invests the same outside of his business at other times, it seems that the amounts should be considered as invested capital in proportion to the time they are employed in the business. Thus, if a sum is employed in the business for six months each year it should be included as invested capital for each of those months in order to ascertain the average invested capital for the year.

TANGIBLE PROPERTY PAID INTO THE TRADE OR BUSINESS. This would seem to mean the tangible property owned by the individual and used in the trade or business with respect to which the tax is imposed. If such property was first employed in the business at some time prior to January 1, 1914, the actual cash value as of

January 1, 1914, may be considered as invested capital. If first employed at a time subsequent to that date the actual cash value at the time it was so first employed is, apparently, the amount which may be included as invested capital.

INTANGIBLE PROPERTY PAID INTO THE TRADE OR BUSINESS. Patents, copyrights, good-will, trade-marks, trade-brands, franchises, or other intangible property may be considered as invested capital only if payment was made therefor, specifically as such, in cash or tangible property. The amount which may be taken as invested capital is the actual cash value of such intangible property, at the time of such payment, not to exceed the actual cash or actual cash value of the tangible property *bona fide* paid therefor at the time of such payment. Literally, this means that the actual cash paid for such property may not be considered as invested capital if the actual cash value of the property was less. Therefore one who, through lack of shrewdness or because of necessity, has paid more for such property than its actual cash value, the law will penalize him by permitting only the actual cash value to be considered as invested capital.[48] As an illustration of the practical effect of this provision, let us assume that an individual is engaged in manufacturing under a patent of his own invention, and that this patent has had a recognized actual cash value of more than a million dollars for a period of five years in the past. Under the law he is permitted to use no part of the value of such patent in ascertaining his invested capital. But if he

48 A practical interpretation would be that the actual cash paid for such property is the actual cash value thereof, but the extreme caution of the Conference Committee in framing this clause permits of the literal interpretation indicated in the text.

should form a corporation and transfer the patent to the corporation, for stock of a par value of one million dollars, the corporation may include in its "invested capital" one million dollars, with respect to such patent, since the law expressly provides that the invested capital of a corporation shall include the actual cash value of patents paid in for stock, at the time of such payment, but not to exceed the par value of such stock at the time of such payment.[49]

Invested Capital of Non-Resident Aliens. A non-resident alien is required by the law to ascertain his "entire invested capital" in the manner indicated in the preceding paragraphs, and his "invested capital" for the purpose of this law is that proportion of the entire invested capital which his net income from sources within the United States bears to his entire net income.[50]

Nominal Capital. The law provides that a flat rate of 8% shall be imposed in cases where a business or trade has no invested capital, or not more than a nominal capital.[51] The statute does not define the meaning of the term "nominal capital," but applying the rules prescribed for determining "invested capital," it would seem that an individual, corporation or partnership doing business entirely on borrowed money would have no capital and consequently be taxable at the flat rate of 8%. It would seem, also, that if the entire capital was invested in stock, or in assets the income from which is not subject to this tax, there would be no invested capital. Thus, an individual doing business entirely on credit is taxed

49 Section 207b.
50 Section 207, last paragraph.
51 Section 209.

at a lesser rate than one doing business with his own capital, but one doing business largely on credit may be very severely penalized, since the small amount of his own capital invested in his business may not be considered merely nominal. The effect might be somewhat as follows: If the capital of a business is one hundred thousand dollars and all of it is borrowed, the business has no "invested capital" and consequently the annual income might be subject only to a tax of 8%. If, however, $90,000 of the capital is borrowed, and $10,000 is paid in by the stockholders, members or individual, as the case may be, there is grave danger that the entire net income will be taxed at the graduated rates after allowing a deduction on merely $10,000 of "invested capital." To evolve a practical definition of the phrase "nominal capital" will be one of the many difficulties of the Treasury Department under this law. No arbitrary line can be drawn beyond which the amount of capital is no longer nominal. What may be nominal capital in one business may be more than nominal in another. A fixed ratio between income and capital cannot be used to draw the line, since the same amount of capital may be merely nominal in two businesses, and the earnings in one may be much greater than the earnings of the other. It would seem, however, that a trade, business, occupation or profession in which the net income is produced by the activity of the persons engaged therein, and not by the use of capital, except incidentally to furnish such persons with business quarters, tools, instruments or appliances, is one to which the flat rate of 8% will apply.

Deductions. From its net income for the taxable year, a corporation, partnership, or individual, domestic or foreign, citizen, resident or non-resident, may deduct

an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual income of the trade or business during the prewar period was of the invested capital for the prewar period, but not less than 7% nor more than 9% of the invested capital for the taxable year. For example, if the average net income during the prewar period was 7%, or less, of the average invested capital for that period, the deduction for the taxable year will be 7%. If the average net income for the prewar period was over 7% but not over 9%, the same percentage of invested capital may be deducted for the taxable year. If the average net income for the prewar period was more than 9%, only 9% of the invested capital for the taxable year may be deducted.[52] If a corporation or partnership was not in existence, or an individual was not engaged in the trade or business, during the whole of any one calendar year during the prewar period, the deduction is 8% of the invested capital for the taxable year.[53] If a corporation or partnership, or a citizen or resident of the United States, (a) had no net income from trade or business during the prewar period or (b) the percentage of net income on invested capital was low, as compared with the percentage, during the same period, of representative corporations, partnerships, and individuals, engaged in a like or similar trade or business, or (c) the net income for the prewar period cannot be ascertained to the satisfaction of the Secretary of the Treasury, the deduction for the taxable year shall be the same percentage as in the case of such representative corporations, partnerships or individuals. For instance, if, due to exceptional circumstances, a particular busi-

[52] Section 203.
[53] Section 204.

ness made only 7% on invested capital during the prewar period, while representative concerns in the same line of business made 10%, the unfortunate business concern will be allowed a deduction for the taxable year of 9% on its invested capital, which is the percentage that will be allowed to the business concerns making 10% during the prewar period. The percentage of net income on invested capital in each trade or business is required by the law to be determined by the Commissioner of Internal Revenue, for the calendar year, and, when applied to a corporation or partnership which has fixed its own fiscal year, the percentage determined by the calendar year ending during such fiscal year shall be used. The unfortunate taxpayer whose earnings were unduly low during the prewar period is required by the law to report on that basis, but may claim the benefit of the rate of representative concerns by filing a claim for abatement of the amount by which the tax so assessed exceeds a tax computed upon the basis of the deduction determined for representative concerns. In such event, collection of that part of the tax covered by such claim for abatement shall not be made until the claim is decided, but the Commissioner of Internal Revenue may require the claimant to give a bond, conditioned for the payment of any tax found to be due, with interest thereon, and if such bond is not given the full amount of tax shall be assessed and the taxpayer be left to find his remedy by a claim for refund.[54]

SPECIFIC EXEMPTION. In addition to the deduction described in the preceding paragraph, a domestic corporation may also deduct the specific sum of $3,000 from

[54] Section 205, Section 203 (d).

its net income for the taxable year.[55] A domestic partnership, or a citizen or resident of the United States, may deduct the sum of $6,000.[56] A foreign corporation, foreign partnership, or a non-resident alien individual, is not entitled to any specific exemption,[57] but if the net income from sources within the United States is less than $3,000, no tax is imposed.[58]

Deductions in Case Invested Capital Is Not Determinable. If the Secretary of the Treasury is unable in any case satisfactorily to determine the invested capital, the amount of the deduction in such case shall be determined by the proportion between the deduction and the net income of representative concerns engaged in a like or similar trade or business. The law requires the Commissioner of Internal Revenue to determine the proportion between the deduction and net income in each trade or business and in the case of a corporation or partnership which has fixed its own fiscal year, the proportion determined for the calendar year ending during such fiscal year shall be used.[59]

Rate of Tax. In the case of taxpayers having invested capital the tax is computed at the following rates:[60]

20% of the amount of the net income in excess of the deduction and not in excess of 15% of the invested capital for the taxable year;

[55] Section 203 (a).
[56] Section 203 (b).
[57] Section 203 (c).
[58] Section 202.
[59] Section 210.
[60] Section 201.

25% of the amount of the net income in excess of 15% and not in excess of 20% of such capital;

35% of the amount of the net income in excess of 20% and not in excess of 25% of such capital;

45% of the amount of the net income in excess of 25% and not in excess of 33% of such capital; and

60% of the amount of the net income in excess of 33% of such capital.

ILLUSTRATIONS. A corporation which has invested capital of $100,000; net income of $50,000 for the taxable year, and is entitled to a deduction of 9% on its invested capital, would compute the tax as follows. The amount of the deduction would be 9% of $100,000 or $9,000, plus the specific exemption of $3,000, making a total of $12,000. The 20% rate would apply to an amount of net income not in excess of 15% of the invested capital ($15,000) less the amount of the deduction ($12,000) or $3,000. The 25% rate would apply to so much of the income as exceeded 15% of the capital and did not exceed 20% of the capital, that is, $5,000. The 35% rate would apply to $5,000 of the income (the amount in excess of 20% and not in excess of 25% of the invested capital). The 45% rate would apply to $8,000 (the amount in excess of 25% and not in excess of 33% of the capital) and the 60% rate would apply to the remainder of the net income, Thus,

Income	Rate	Amount
$15,000 — $12,000 = $3,000	20%	$ 600
5,000	25%	1,250
5,000	35%	1,750
8,000	45%	3,600
17,000	60%	10,200
$50,000		$17,400

Rate of Tax in Case of Nominal Capital. In the case of a trade or business having no "invested capital" or not more than a nominal capital a tax of 8% is imposed upon the net income of such trade or business, in excess of the specific exemption of $3,000 allowed to domestic corporations or $6,000 allowed domestic partnerships and citizens or residents of the United States. In the case of foreign corporations, foreign partnerships and non-resident aliens the tax is imposed upon the entire net income without any deduction,[61] unless such net income from sources within the United States is less than $3,000, in which case no tax is imposed.[62]

Tax Paid Under Former Excess Profits Tax Law. The excess profits tax law of March 3, 1917, is repealed by this law, and any amount paid on account of the tax imposed by that law is required to be credited toward the payment of the tax imposed by this law. If payment under the former law exceeds the amount of the tax imposed under this law, the excess may be refunded under the provisions relating to the refund of taxes.[63]

Annual Returns. Every foreign partnership having a net income of $3,000 or more for the taxable year, and every domestic partnership having a net income of $6,000 or more for the taxable year is required to file a return annually, at the same time and in the same manner as is prescribed for income-tax returns under the 1916 Law. Partnerships having less income than above indicated are not required to file returns and are subject

61 Section 209.
62 Section 202.
63 Section 214.

to no tax.[64] Other taxpayers will report the information necessary to assess this tax on their income tax returns.

Administrative Provisions. All administrative, special and general provisions of law in relation to the assessment, remission, collection, and refund of internal revenue taxes, not specifically repealed, and not inconsistent with the provisions of this law, are extended and made applicable to all the provisions of this law and to the tax imposed thereby. All provisions of the 1916 Income Tax Law, as amended, relating to returns and payment of the income tax, including penalties, are made applicable to the tax imposed by this law.[65] The Commissioner of Internal Revenue is authorized to make all necessary regulations for carrying out the provisions of this law, and may require any corporation, partnership, or individual, subject to the provisions of this law, to furnish him with such facts, data, and information as in his judgment are necessary to collect the tax.[66]

64 Section 211.
65 Section 212.
66 Section 213.

CHAPTER 46

THE CAPITAL STOCK TAX

This tax is popularly known as the capital stock tax, but the statute describes it as "a special excise tax with respect to carrying on or doing business."[1] The tax is imposed upon, "Every corporation, joint-stock company or association, now or hereafter organized in the United States for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States, or any state or territory of the United States" and upon, "Every corporation, joint-stock company or association, or insurance company, now or hereafter organized for profit under the laws of any foreign country and engaged in business in the United States." The tax is imposed for the privilege of carrying on or doing business for the taxable year and is payable in advance by every taxable corporation engaged in business during any part of the preceding year.

Definitions. The word "corporation" as used in this chapter means, unless otherwise stated, a corporation, joint-stock company, association, or insurance company. The phrase "taxable year" is the fiscal year of the Government beginning July one of each calendar year and ending on the last day of June of the year following.

[1] Act of September 8, 1916, § 407.

The phrases "preceding year" and "preceding taxable year" as used in the Statute mean the twelve-month period ending June 30, preceding the taxable year.

Domestic Corporations Subject to the Tax. The tax applies to corporations, joint-stock companies or associations organized in the United States, provided they are (a) organized for profit, (b) have capital stock represented by shares, (c) were engaged in business during the preceding taxable year, and (d) are not exempt organizations under the provisions of Section 11 of the 1916 Income Tax Law.[2] It should be noted that the law applies not only to corporations but to all associations "organized in the United States" and in this respect seems to be broader in its scope than the 1909 Law, which was construed to apply only to corporations, joint-stock companies or associations "organized under the laws of the United States or of any state or territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia."[3] It was apparently the intent of Congress to make this law apply to associations which were held not to be taxable under the 1909 Law, because not organized under some statute.[4]

[2] For a discussion of corporations exempt from tax under the 1916 Income Tax Law, see Chapter 15.

[3] Act of August 5, 1909, § 38.

[4] It was the intention of Congress to embrace within the 1909 Law only such corporations and joint-stock associations as are organized under some statute or derived from that source some quality or benefit not existing at the common law. (Eliot v. Freeman, 220 U. S. 178.) This was a case involving the so-called "Massachusetts Real Estate Trusts" and the Treasury Department has indicated that it will not hold such trusts subject to the capital stock tax. It seems, nevertheless, that Congress had a definite intention to include such organizations by using the phrase

The language of the two laws not being identical, decisions under the 1909 Law are not controlling with respect to this law. It seems, rather, that any corporation or association subject to the 1916 Income Tax Law would be subject to the capital stock tax law (providing the other conditions co-exist) since the language of Section 10(a) of the 1916 Law has phraseology very similar to the language of this law.[5]

Insurance Companies. It seems that an insurance company in order to be subject to this tax must be organized under the laws of the United States, or any state or territory of the United States. An insurance company not organized under some statute would not be subject to the tax although it may have capital stock represented by shares. If organized under a statute the other elements must co-exist, that is, it must have been organized for profit, must be engaged in business and must not be one of the classes of corporations specifically enumerated as exempt in the 1916 Income Tax Law. Although the law imposes the tax on insurance companies without reference to whether or not they have capital stock represented by shares it has been held by the Treasury Department, inasmuch as the basis of tax is the fair value of the stock of the corporation, that mutual insurance companies and other associations not having capital stock represented by shares will be held

''organized in the United States'' instead of the phrase ''organized under the laws of the United States or of any state or territory of the United States,'' which latter phrase was used in the 1909 Law and was the precise language on which this case was decided.

5 For rulings under the 1916 Law on joint-stock companies and associations see Chapter 12.

exempt from the tax, in the absence of a basis for the computation thereof.[6]

Holding Companies. A holding company, as such, is not exempt from this tax. The Treasury Department has held that a holding company organized in the United States for the purpose of acquiring and holding capital stock of subsidiary companies, and actually engaged in holding such stock, voting thereon, receiving dividends thereon, and distributing money among its own shareholders, is engaged in business and is subject to this tax.[7] Both holding companies and their subsidiary corporations are required to file returns and pay the tax, no deduction being allowed to the holding corporation for the tax assessed on its subsidiary.[8]

Subsidiary Companies. A subsidiary company is taxed on the fair value of its capital stock, although the parent company is also taxed on the value of its capital stock, represented by the stock of such subsidiary.[9]

It has been held that in order to determine the fair value of capital stock of subsidiary companies, the fair value of the capital stock of the parent company, determined from the prices listed on an exchange or from actual sales, may be apportioned among the subsidiaries according to the amount of net profits earned by each during the year, making due allowance for the amount of net profits earned by the parent corporation from actual operations and investments or holdings in stock of companies other than its subsidiaries. As an illustration,

6 T. D. 2364.
7 T. D. 2429.
8 T. D. 2503.
9 T. D. 2493.

assume that the fair value of the capital stock of a parent company is $5,000,000 and that it derived one-fifth of its income during the preceding year from operations and investments in securities, other than stock of its two subsidiaries. In such case, one-fifth of the fair value of its capital stock will be ascribed to capital used in its operations and outside investments, four-fifths, or $4,000,000, being ascribed to the capital stock of the subsidiaries. Assume further, that one of the subsidiaries had net income of $600,000 and the other had net income of $200,000. The aggregate net income of the subsidiaries would be $800,000, three-fourths of which would be earned by the one and one-fourth by the other. Consequently, the value of the capital stock of the one would be three-fourths of $4,000,000, and the value of the capital stock of the other would be one-fourth, or $3,000,000 and $1,000,000 respectively. Where the value of the stock of a subsidiary company is determined on this basis, the Treasury Department requires a statement showing the fair value of capital stock of the parent company, its earnings for the preceding year, the amount of such earnings derived from operations and outside investments, and the net earnings of each subsidiary.[10]

Corporations Not Engaged in Business. Since this is a tax with respect to the carrying on or doing business by a corporation, it follows that only such corporations as are engaged in business are subject to the tax. The meaning of the term "engaged in business" was defined by a number of decisions under the 1909 Law, with particular reference to cases where corporations had ceased to do business. Thus, it was held that where a corpora-

10 T. D. 2493 as amended by T. D. 2509.

tion, originally organized for the purpose of owning and renting an office building, leased its property for 130 years, its sole authority under its charter thereafter being to hold the title subject to the lease and to receive and distribute the rentals which might accrue under the terms of the lease, or the proceeds of any sale of the land if it should be sold, was not engaged in business within the meaning of that law.[11] In another case, it was held that a railroad corporation which had leased its property for a term of years, and parted with its control and management, maintaining, however, its corporate organization, collecting rentals from the lessee, and distributing the same among its stockholders, was not engaged in business.[12] Where, however, a corporation was organized to build and lease property, the fact that it had leased all of its property and did nothing except collect and distribute the rents, did not exempt it from the tax, since such collection and distribution of rents from the leased property was the business for which it was organized.[13] These and other decisions[14] will be followed by the

11 Zonne v. Minneapolis Syndicate, 220 U. S. 187. In a later case it was held that, although a corporation might have power to do business under its charter, if it had leased all its property and was merely collecting rent it was not engaged in business. U. S. v. Emery, etc. Co., 237 U. S. 28.

12 McCoach v. Mine Hill & Schuylkill Haven R. R. Co., 228 U. S. 295.

13 Rio Grande Junction Ry. Co. v. U. S., 51 Ct. Cls. 274.

14 Other cases arising under the 1909 Law are Anderson v. Morris & Essex R. R. Co., 216 Fed. 83; Cambria Steel Co. v. McCoach, 225 Fed. 278; Jasper, etc. Ry. Co. v. Walker, 238 Fed. 533; Lewellyn v. Pittsburgh, et. R. R. Co., 222 Fed. 177; McCoach v. Continental Passenger Ry. Co., 233 Fed. 976; Miller v. Snake River Valley R. R. Co., 223 Fed. 946; New York Central v. Gill, 219 Fed. 184; New York Mail, etc. Co. v. Anderson, 234 Fed. 590; Philadelphia, etc. R. R. Co. v. Lederer, 242 Fed. 492; Philadelphia

Treasury Department where the decisions are by the United States Supreme Court or, if by the lower courts, have been acquiesced in by the Department. Corporations organized for the purpose of buying, owning, exploring, developing, leasing, improving, selling and dealing in lands, mining properties, tenements, and hereditaments, are considered to be engaged in business if they perform any of their powers. It is not necessary that such a corporation be an operating company in order to be taxable under this law. If a corporation is doing any one of the several things it is authorized to do, by its charter, it is "engaged in business" and subject to this tax.[15] Corporations in the possession and control of receivers appointed by a court are not engaged in business during the period of the receivership.[16]

Engaged in Business During Preceding Taxable Year. A corporation is not subject to tax in any taxable year unless these two conditions co-exist: (a) it must have been carrying on business during some part of the preceding year, and (b) it must be carrying on business in the taxable year. It is not necessary, however, that the corporation should have been engaged in business during the entire preceding year. If it was engaged in business at some time during the preceding year, the length of time has no bearing upon the amount of tax due. A corporation commencing business on the last day of the preceding year is held by the Treasury Department to

Traction Co. v. McCoach, 224 Fed. 800; Public Service Electric Co. v. Herold, 229 Fed. 902; Traction Companies v. Collector of Internal Rev., 223 Fed. 984; Wilkes-Barre, etc. Traction Co. v. Davis, 214 Fed. 551.

15 T. D. 2457.

16 T. D. 2424.

be subject to the tax to the same extent as though it had been engaged in business for the entire year, and the full rate of tax for the taxable year is imposed.[17]

Inactive Corporations. A corporation not engaged in business at the beginning of the taxable year is not required to file a return or pay a tax, although it may have been engaged in business during a part of the preceding year. If such corporation resumes business at any time during the taxable year, it will be required, at that time, to make a return and pay the tax for the proportion of the year in which it intends to do business. In such cases the tax is computed proportionately from the first day of the month in which it engages in business to the end of the taxable year. Thus, if a corporation was engaged in business during some part of the taxable year beginning July 1, 1916, and ending June 30, 1917, but was not engaged in business on July 1, 1917, it was required to file no return and pay no tax at that time. If it subsequently engaged in business in September, 1917, the return was required to be filed and the tax be paid at that time, for ten-twelfths of the full year. If an inactive corporation was not engaged in business during any part of the preceding year, it is not taxed in the year it resumes activity, but makes a return and pays the tax at the beginning of the next taxable year.

Corporations Ceasing to Do Business During the Taxable Year. If a corporation has paid this tax at the beginning of a taxable year and ceases to do business before the close of that year, no refund of any amount of the tax is allowed for that portion of the year in which it does no business.[18]

17 T. D. 2417.

18 See § 3237, Rev. Stat.

Basis of Tax. The basis of the tax in the case of all domestic corporations is "the fair average value of the capital stock for the preceding year." The tax is imposed upon the fair value of the entire capital stock of domestic corporations, no deduction being allowed in cases where a part of the capital is invested in foreign countries.[19]

Fair Value of Capital Stock. The law provides in the case of domestic corporations, that in estimating the value of capital stock, the surplus and undivided profits shall be included; provided, that in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included in estimating the value of the capital stock, surplus and undivided profits.[20] The Treasury Department has prescribed three methods by which the fair value of the capital stock may be determined: Case 1, where the stock is listed on an exchange; Case 2, where the stock is not listed on any exchange, but sales thereof have been actually made, and the price paid for the stock is known to the officer making the return, or can be discovered by him, and Case 3, where the stock is not listed and no actual sales have been made, or if the price at which sales have been made is not known to the officer making the return.[21] Cases 1

19 T. D. 2417.

20 Act of September 8, 1916, § 407. The methods prescribed by the Treasury Department for ascertaining the fair value of capital stock eliminate such deposits and reserve funds maintained or held in the United States and the amount thereof is not deducted after computing the value of the stock by any one of the three methods described below. (T. D. 2503.)

21 T. D. 2364.

and 2 present comparatively few difficulties and cover a comparatively small number of corporations. Case 3 has more general application. The rules applicable to each of the three cases are discussed below.

INCREASE OR DECREASE OF CAPITAL STOCK. If the corporation has increased or decreased its capital stock during the preceding year, a statement should be attached to the back of its return setting forth the number of shares of stock outstanding each month with the fair average value of the stock for that month computed under one of the three cases.[22]

CAPITAL STOCK OUTSTANDING. In estimating the value of the capital stock outstanding so-called "treasury stock" which has once been issued and thereafter acquired by the company for value is considered as capital outstanding. Preferred stock and common stock are to be considered in estimating the total fair average value.[23]

Case 1. If the stock is listed on any exchange its fair value is determined by adding the quoted highest bid price for the stock on the last business day of each month during the preceding fiscal year (or if no bid price was quoted on the last day, then the latest day in the month on which a bid price was quoted), and dividing by twelve, the result being the average bid price per share for that year.[24] A corporation may, if it prefers, average the fair value throughout the entire fiscal year by showing on a statement, attached to the back of the return, the highest bid price for stock on each day

22 T. D. 2503.

23 Letter from Treasury Department dated December 19, 1916.

24 T. D. 2364.

throughout the year.[25] Where stock listed on an exchange is subject to great fluctuation, and the prices do not indicate the fair value of the stock, the corporation may attach a statement to its return setting forth the reasons why the bid prices are not considered an indication of the value of the stock, which statement will be taken into consideration when assessment of the tax is made.[26]

Case 2. If the stock is not listed on any exchange, but sales thereof have been actually made, and the price paid for the stock is known to the officer making the return, or can be discovered by him, the average price at which sales were made during the preceding fiscal year shall be the determining factor in ascertaining the fair value per share.[27] Corporations estimating the fair value of their stock under Case 2, are required to take "the average price at which sales were made during the preceding fiscal year" and not the average selling price per share. Thus, if ten shares were sold at $100, and one thousand shares were sold at $70, the "average price at which sales were made" would be $85. The average selling price in such case would be $70.29, but this price will not be accepted as an average fair value. A corporation protesting against the computation of the value of stock by this method may file a statement with its return setting forth the facts in detail and requesting the Collector to bring the case to the attention of the Treasury Department when the return is forwarded to that Department for audit.[28] When sales have been made during the year

25 T. D. 2503.
26 Letter from Treasury Department dated January 22, 1917.
27 T. D. 2364.
28 T. D. 2423.

under circumstances which do not indicate the true value of the stock, the prices which were paid should be stated, and, in addition, the value of the stock may be estimated under Case 3, a statement being attached to the return explaining why the figures in Case 2 do not indicate the fair average value of the stock.[29] If there are not enough sales to establish a basis for estimating the fair value of the total capital stock, the corporation will be required to fill out Case 3.[30]

Case 3. If Case 1 and Case 2 can not be applied, viz., the stock is not listed on any exchange, and no actual sales have been made during the preceding fiscal year, or if the price at which sales have been made is not known to the officer making the return, the fair average value of the capital stock shall be estimated, and the surplus and undivided profits for the preceding fiscal year will be taken into consideration as required by the statute, as well as the nature of the business, its earning capacity and average dividends paid, or profits earned during the preceding five years.[31] The Treasury Department requires the return to show the amount of net income reported on the federal income tax returns for five preceding years and the number of shares outstanding on December 31 of each of such years, together with the percentage of earnings on each share of stock. A 10% earning capacity, so determined, is taken as prima facie evidence that the stock is worth par. If the earning capacity is more or less than 10% the estimated fair value per share is taken to be correspondingly more or less than par. Thus, if the earning capacity is shown

[29] Letter from Treasury Department dated January 22, 1917.
[30] T. D. 2503.
[31] T. D. 2364.

to be 8% the tax will be assessed on a "fair average value" of 80% of par. If the earning capacity is shown to be 12% the fair average value is taken to be 120% of par. The assessment is based on this prima facie valuation unless the corporation submits proof that such valuation is not fair and equitable. The estimated fair value per share having been ascertained, as above, such sum is multiplied by the number of shares outstanding on June 30 preceding the time of making the return, in order to ascertain the fair value of the capital stock. If, however, the number of shares outstanding during the year has varied, the average number of shares outstanding may be taken instead of the total number of shares outstanding on June 30. Thus, if a corporation has 500 shares outstanding for four months, and 1,000 shares outstanding for eight months, the average number of shares outstanding for the year will be the total of the number outstanding at the end of each month divided by twelve, or 833 shares. Should the officers of a corporation consider that a 10% earning capacity does not warrant a valuation of par for their stock they may attach to the return a statement under oath, reciting the reasons for their conclusion and giving a statement of the assets and liabilities as of June 30 preceding, or as of the end of their last fiscal year, and these factors will be given consideration in making the assessment.

Exceptions to Case 3. Corporations that have no regular earnings, such as companies organized for the purpose of developing and selling timberland, mining property, and other real property, and corporations that have earned no profits in the past five years or have only been engaged in business one or two years, can not very well estimate the value of the stock from their earning

capacity. It has also been found that the earning capacity is not an equitable method in computing the fair value of real estate and investment companies. Such corporations are permitted, therefore, to file a detailed statement, attached to the back of the return, showing their assets and liabilities as of June 30, last, or as of the end of their last fiscal year, and may estimate the fair value of the stock from the book value thereof.[32] If the book value of assets is fictitious and does not represent the true value of the property, this fact should be fully explained on the statement and the true value of the property should be stated, together with any other data as to the hazards of the business or conditions peculiar to the business which in the judgment of the officers tends to affect the value of the stock.

Exemption. After computing the fair value of the capital stock, the law permits an exemption of $99,000, that is, the tax is imposed only upon the fair value of the capital stock in excess of $99,000.[33]

Rate of Tax. The tax is an amount equivalent to fifty cents for each one thousand dollars of the fair value of the capital stock. It is computed on each full one thousand dollars and not on any fractional part thereof.[34] Thus, if a corporation has a fair value of capital stock of $186,656, the fraction over $186,000 is eliminated in computing the tax.

Deduction of Munition Manufacturers' Tax. If the corporation has paid the tax imposed under the Act of

32 T. D. 2503, Letter from Treasury Department dated August 17, 1917.

33 Act of September 8, 1916, § 407.

34 T. D. 2364.

September 8, 1916, on munition manufacturers, the amount of such tax may be deducted from the tax found to be due under this Act and only the remainder, if any, will be payable. The deduction of the munition manufacturers' tax is allowed only with respect to such tax actually paid since the making of the last previous return. No deduction can be made for a tax assessed but not paid at the time of making the capital stock tax return.[35]

Tax Due. This tax is an excise tax on the privilege of doing business, similar to occupational taxes imposed on individuals. Being a privilege or occupational tax, it is payable annually, in advance, in July, the beginning of the Government's fiscal year. The tax is payable to the collector, at any time after July 1, but penalties for non-payment do not attach until ten days after notice and demand therefor has been served by the collector upon the taxpayer.[36]

Returns. The capital stock tax return is required to be filed in July of each year.[37] The return is filed with the collector of the district in which the principal place of business of the corporation is located. Forms are sent to taxable corporations known to collectors, but failure to receive a blank form does not relieve a corporation from the penalties prescribed by law for failure to make the return within the time required.

35 T. D. 2364.

36 T. D. 2423. See Chapter 36 for rulings as to notice and demand.

37 T. D. 2364. The form to be used by domestic corporations is known as Form 707.

WHEN REQUIRED. A return is required of every domestic corporation engaged in business, having a capital stock issued and outstanding, represented by shares, of the "fair average value" of $75,000 or over, regardless of the par value of its capital stock, unless such corporation was not engaged in business during the preceding taxable year.[38] Since the Treasury Department has adopted an arbitrary rule of valuing capital stock on the theory that a 10% earning capacity makes the stock worth par, a corporation may be required to file a return, and be subject to the penalties for failure so to do, notwithstanding that the officers of the company consider the stock to be worth less than $75,000. Thus, a corporation having a capital stock outstanding of $50,000 par value, on which it earns 15%, will be required to make a return, the "fair average value" being 150% of par, according to the rule laid down by the Treasury Department. Similarly, a corporation having $25,000 par value of stock outstanding, on which it earns 30%, will be required to file a return. To determine whether or not a corporation should file a return, the percentage of earnings per share should be multiplied by ten to ascertain the percentage of value of its shares over or under par. If this figure, multiplied by the number of shares outstanding, gives a product of $75,000 or more, a return should be filed in order to avoid penalties.

EXTENSION OF TIME. An extension of time for filing the capital stock return may be obtained in the case of sickness or absence, such extension not to exceed thirty days.[39]

[38] T. D. 2364.
[39] T. D. 2364.

Penalty for Failure to Make Return. If a corporation fails to make a return on or before the last day of July in any year, the collector may make a return from such information as he can obtain through testimony or otherwise, and a penalty of 50% of the amount of the tax so found due will be added, unless a return is voluntarily made and without notice from the collector and it is shown that the failure to file it was due to a reasonable cause and not to wilful neglect.[40] In case of false or fraudulent return is made the Commissioner will add 100% of the amount of the tax. "Every person who carries on any business or occupation for which special taxes are imposed by this title, without having paid the special tax therein provided, shall, besides being liable to the payment of such special tax, be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not more than $500, or be imprisoned not more than six months, or both, in the discretion of the court."[41] The 50% penalty for delinquency in filing returns, as well as the specific penalty for carrying on business without payment of special tax, will be strictly enforced against corporations that fail to file returns of capital-stock tax within the time prescribed by law or by the collector.[42]

Penalty for Delay in Paying Tax. Upon failure to pay the tax assessed within ten days after notice and demand, a penalty of 5% of the tax unpaid, and interest

40 T. D. 2364; Rev. Stat. § 3176, as amended. See p. 422.

41 Act of September 8, 1916, § 408, T. D. 2364.

42 For procedure in compromising the specific penalty see Chapter 37.

at the rate of 1% per month until paid, is added to the amount of such tax.[43]

Foreign Corporations. Every corporation, joint-stock company or association, or insurance company, organized for profit under the laws of any foreign country and engaged in business in the United States, is subject to this tax, with respect to the carrying on or doing business in the United States by such corporation, joint-stock company or association, or insurance company, the tax being based upon the capital invested in the transaction of business in the United States. It is to be noted that a foreign corporation is not subject to this tax merely because it receives income from sources within this country. To be taxable, a foreign corporation must be carrying on or doing business in the United States and must have capital actually invested in the transaction of such business.[44] The chapter on foreign corporations, in the foregoing part of this book, contains decisions and rulings which define what is doing business by foreign corporations, and such rulings and decisions have application to this tax. It should be borne in mind, however, that some of the rulings with respect to the taxability of foreign corporations under the income tax law have no application to this law, since this tax is imposed only where the foreign corporation is carrying on or doing business in this country and has capital invested in the transaction of such business.[45]

[43] See Chapter 36 for rules with respect to assessment and payment of the tax.

[44] Act of September 8, 1916, § 407.

[45] Laurentide Co., Limited, v. Durey, 231 Fed. 223, and Bryant and May, Limited, v. Scott, 226 Fed. 875, are cases in point. See p. 178, supra.

Basis of Tax. In the case of foreign corporations, the tax is imposed upon the capital actually invested in the transaction of its business in the United States, the amount of the tax being computed on the basis of the average amount of capital so invested during the preceding year. Bank accounts carried by a foreign corporation in this country are to be considered in computing the amount of capital actually invested if the money is carried on the books of the corporation as capital invested in its business in this country,[46] but not if the money is kept here merely for convenience or investment.

Foreign Insurance Companies. Foreign insurance companies are permitted, by statute, to exclude from capital actually invested in the transaction of business in the United States, such deposits or reserve funds as they are required by law or contract to maintain or hold in the United States for the protection of or payment to or apportionment among policyholders. The Treasury Department has held that the amount of capital invested in the transaction of business in the United States by foreign insurance companies is the amount of "surplus to policyholders," as shown by the conventional form of report to State insurance departments. Foreign insurance companies are permitted to state the amount of "surplus to policyholders" as shown by the report for the last fiscal year of the company. The only deduction allowed by the Treasury Department is the amount of deposits actually required by states in which the company is transacting business.[47]

Exemption. As stated above, an exemption of $99,000 is allowed from the capital stock of each domestic cor-

46 Letter from Treasury Department dated February 10, 1917.
47 T. D. 2503.

poration. In the case of foreign corporations the exemption is such proportion of $99,000 as the amount of capital actually invested in business in the United States bears to the total amount invested in the transaction of business within and without the United States. If a foreign corporation has all its capital invested here, it will be entitled to the full amount of $99,000, but if it has only a fraction of its capital invested here, the exemption will be such fraction of $99,000. This exemption is allowed only if the foreign corporation makes a return to the Commissioner of Internal Revenue showing the amount of capital invested in the transaction of business outside the United States, so that the Commissioner of Internal Revenue may compute the proportion of the exemption to which the corporation is entitled.[48]

RATE OF TAX. The rate of tax is 50 cents on each one thousand dollars of the capital actually invested in the transaction of business in this country, in excess of the amount of the exemption. If the capital so invested exceeds an amount in even thousands, the fraction above the even thousand may be disregarded, as in the case of domestic corporations. The tax is due at the same time as in the case of domestic corporations and the same credit for payment of munition manufacturers' tax is extended to foreign corporations.[49]

RETURNS. A return is required of every foreign corporation irrespective of the amount of capital employed either in this country or elsewhere in the transaction of its business.[50] The return is required to be filed at the

48 Act of September 8, 1916, § 407.
49 See p. 547.
50 T. D. 2364.

same time and in the same manner as in the case of domestic corporations and the same penalties accrue for neglect or failure. Returns are filed with the local collector under the rules which apply to the filing of returns of annual net income.[51]

Administration of the Law. All Administrative or special provisions of the internal revenue laws including the laws relating to the assessment of taxes, so far as applicable, are extended to and made a part of the section imposing the capital stock tax and every corporation liable to the capital stock tax is required to keep such records and render, under oath, such statements and returns, and comply with such regulations as the Commissioner of Internal Revenue may prescribe.[52]

51 See pp. 548 and 189.
52 Act of September 8, 1916, § 409.

TEXT OF 1916 LAW AS AMENDED[1]

TITLE 1 OF THE ACT OF SEPTEMBER 8, 1916, AS AMENDED BY ACT OF OCTOBER 3, 1917.

PART I.—ON INDIVIDUALS

Sec. 1. (*a*) That there shall be levied, assessed, collected, and paid anually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources within the United States by every individual, a non-resident alien, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise.

(*b*) In addition to the income tax imposed by subdivision (*a*) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a non-resident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds $20,000 and does not exceed $40,000, two per centum per annum upon the amount by which such total net income exceeds $40,000 and does not exceed $60,000, three per centum per annum upon the amount by which such total net income exceeds $60,000 and does not exceed $80,000, four per centum per annum upon the amount by which such total net income exceeds $80,000 and does not exceed $100,000, five per centum per annum upon the amount by which such total net income exceeds $100,000

[1] Matter repealed by the amendment is omitted. New matter is shown in italics.

and does not exceed $150,000, six per centum per annum upon the amount by which such total net income exceeds $150,000 and does not exceed $200,000, seven per centum per annum upon the amount by which such total net income exceeds $200,000 and does not exceed $250,000, eight per centum per annum upon the amount by which such total net income exceeds $250,000 and does not exceed $300,000, nine per centum per annum upon the amount by which such total net income exceeds $300,000 and does not exceed $500,000, ten per centum per annum upon the amount by which such total net income exceeds $500,000 and does not exceed $1,000,000, eleven per centum per annum upon the amount by which such total net income exceeds $1,000,000 and does not exceed $1,500,000, twelve per centum per annum upon the amount by which such total net income exceeds $1,500,000 and does not exceed $2,000,000, and thirteen per centum per annum upon the amount by which such total net income exceeds $2,000,000.

For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation, joint-stock company or association, or insurance company, except that in the case of non-resident aliens such income derived from sources without the United States shall not be included.

All the provisions of this title relating to the normal tax on individuals, so far as they are applicable and are not inconsistent with this subdivision and section three, shall apply to the imposition, levy, assessment, and collection of the additional tax imposed under this subdivision.

(*c*) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

INCOME DEFINED

Sec. 2. (*a*) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shal include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest

in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

(*b*) Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except where the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be: Provided, That where the income is to be distributed annually or regularly between existing heirs or legatees, or beneficiaries the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

Such trustees, executors, administrators, and other fiduciaries are hereby indemnified against the claims or demands of every beneficiary for all payments of taxes which they shall be required to make under the provisions of this title, and they shall have credit for the amount of such payments against the beneficiary or principal in any accounting which they make as such trustees or other fiduciaries.

(*c*) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

ADDITIONAL TAX INCLUDES UNDISTRIBUTED PROFITS

Sec. 3. For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however

created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.

INCOME EXEMPT FROM LAW

Sec. 4. The following income shall be exempt from the provisions of this title:

The proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States (*but, in the case of obligations of the United States issued after September first, nineteen hundred and seventeen, only if and to the extent provided in the Act authorizing the issue thereof*) or its possessions or securities issued under the provisions of the Federal Farm Loan Act of July seventeenth, nineteen hundred and sixteen; the compensation of the present President of the United States during the term for which he has been elected, and the judges of the

Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government.

DEDUCTIONS ALLOWED

Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(*a*) For the purpose of the tax there shall be allowed as deductions—

First. The necessary expenses actually paid in carrying on any business or trade, not including personal, living, or family expenses;

Second. All interest paid within the year on his indebtedness *except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title;*

Third. Taxes paid within the year imposed by the authority of the United States (*except income and excess profits taxes*) or of its Territories, or possessions, or any foreign country, or *by* the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits;

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;

Sixth. Debts due to the taxpayer actually ascertained to be worthless and charged off within the year;

Seventh. A reasonable allowance for the exhaustion, wear and

tear of property arising out of its use or employment in the business or trade;

Eighth. (*a*) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (*b*) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made. No deductions shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made;

Ninth. Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.

CREDITS ALLOWED

(*b*) For the purpose of the normal tax only, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any corporation, joint-stock company or association, trustee or insurance company, which is taxable upon its net income as hereinafter provided;

(c) A like credit shall be allowed as to the amount of income, the normal tax upon which has been paid or withheld for payment at the source of the income under the provisions of this title.

NON-RESIDENT ALIENS

Sec. 6. That in computing net income in the case of a non-resident alien—

(a) For the purpose of the tax there shall be allowed as deductions—

First. The necessary expenses actually paid in carrying on any business or trade conducted by him within the United States, not including personal, living, or family expenses;

Second. The proportion of all interest paid within the year by such person on his indebtedness (*except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title*) which the gross amount of his income for the year derived from sources within the United States bears to the gross amount of his income for the year derived from all sources within and without the United States, but this deduction shall be allowed only if such person includes in the return required by section eight all the information necessary for its calculation;

Third. Taxes paid within the year imposed by the authority of the United States (*except income and excess profits taxes*), or of its Territories, or possessions, or *by* the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, paid within the United States, not including those assessed against local benefits;

Fourth. Losses actually sustained during the year, incurred in business or trade conducted by him within the United States, and losses of property within the United States arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: Provided, That for the purpose of ascertaining the amount of such loss or losses sustained in trade, or speculative transactions not in trade, from the same or any kind of property acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss or losses sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profit arising therefrom in the United States;

Sixth. Debts arising in the course of business or trade conducted by him within the United States due to the taxpayer actually ascertained to be worthless and charged off within the year;

Seventh. A reasonable allowance for the exhaustion, wear and tear of property within the United States arising out of its use or employment in the business or trade; (*a*) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (*b*) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowance authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

(*b*) There shall also be allowed the credits specified by subdivisions (*b*) and (*c*) of section five.

(*c*) *A non-resident alien individual shall receive the benefit of the deductions and credits provided for in this section only by filing or causing to be filed with the collector of internal revenue a true and accurate return of his total income, received from all sources, corporate or otherwise, in the United States, in the manner prescribed by this title; and in case of his failure to file such return the collector shall collect the tax on such income, and all property belonging to such non-resident alien individual shall be liable to distraint for the tax.*

PERSONAL EXEMPTION

Sec. 7. That for the purpose of the normal tax only, there shall be allowed as an exemption in the nature of a deduction from the amount of net income of each *citizen or resident of the United States*, ascertained as provided herein, the sum of $3,000, plus $1,000 additional if the person making the return be a head of a family or a married man with a wife living with him, or plus the sum of $1,000 additional if the person making the return be a married woman with a husband living with her; but in no event shall this additional exemption of $1,000 be deducted by both a husband and a wife: Provided, That only one deduction of $4,000 shall be made from the aggregate income of both husband and wife when living together: *Provided further, That if the person making the return is the head of a family there shall be an additional exemption of* $200 *for each child dependent upon such person, if under eighteen years of age, or if incapable of self-support because mentally or physically defective, but this provision shall operate only in the case of one parent in the same family:* Provided further, That guardians or trustees shall be allowed to make this personal exemption as to income derived from the property of which such guardian or trustee has charge in favor of each ward or cestui que trust: Provided further, That in no event shall a ward or cestui que trust be allowed a greater personal exemption than as provided in this *section*, from the amount of net income received from all sources. There shall also be allowed an exemption from the amount of the net income of estates of deceased *citizens or residents of the United States* during the period of administration or settlement, and of trust or other estates *of citizens or residents of the United States* the income of which is not distributed annually or regularly under the provisions of *subdivision* (*b*) of section two, the sum of $3,000, including such deductions as are allowed under section five.

Sec. 8. (*a*) The tax shall be computed upon the net income, as thus ascertained, of each person subject thereto, received in each preceding calendar year ending December thirty-first.

(*b*) On or before the first day of March, nineteen hundred and seventeen, and the first day of March in each year thereafter, a true and accurate return under oath shall be made by each person of lawful age, except as hereinafter provided, having a net income of $3,000 or over for the taxable year to the collector

of internal revenue for the district in which such person has his legal residence or principal place of business, or if there be no legal residence or place of business in the United States, then with the collector of internal revenue at Baltimore, Maryland, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth specifically the gross amount of income from all separate sources, and from the total thereof deducting the aggregate items of allowances herein authorized: Provided, That the Commissioner of Internal Revenue shall have authority to grant a reasonable extension of time, in meritorious cases, for filing returns of income by persons residing or traveling abroad who are required to make and file returns of income and who are unable to file said returns on or before March first of each year: Provided further, That the aforesaid return may be made by an agent when by reason of illness, absence, or non-residence the person liable for said return is unable to make and render the same, the agent assuming the responsibility of making the return and incurring penalties provided for erroneous, false, or fraudulent return.

(*c*) Guardians, trustees, executors, administrators, receivers, conservators, and all persons, corporations, or associations, acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals. Such fiduciary shall make oath that he has sufficient knowledge of the affairs of such person, trust, or estate to enable him to make such return and that the same is, to the best of his knowledge and belief, true and correct, and be subject to all the provisions of this title which apply to individuals: Provided, That a return made by one of two or more joint fiduciaries filed in the district where such fiduciary resides, under such regulations as the Secretary of the Treasury may prescribe, shall be a sufficient compliance with the requirements of this paragraph: *Provided further, That no return of income not exceeding* $3,000 *shall be required except as in this title otherwise provided.*

[Subdivision (*d*) repealed. This subdivision related to withholding the tax at the source.]

(*e*) Persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share

of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid under the provisions of this title: Provided, That from the net distributive interests on which the individual members shall be liable for tax, normal and additional, there shall be excluded their proportionate shares received from interest on the obligations of a State or any political or taxing subdivision thereof, and upon the obligations of the United States (*if and to the extent that it is provided in the Act authorizing the issue of such obligations of the United States that they are exempt from taxation*) and its possessions, and that for the purpose of computing the normal tax there shall be allowed a credit, as provided by section five, subdivision (*b*), for their proportionate share of the profits derived from dividends. Such partnership, when requested by the Commissioner of Internal Revenue, or any district collector, shall render a correct return of the earnings, profits, and income of the partnership, except income exempt under section four of this Act, setting forth the item of the gross income and the deductions and credits allowed by this title, and the names and addresses of the individuals who would be entitled to the net earnings, profits, and income, if distributed. *A partnership shall have the same privilege of fixing and making returns upon the basis of its own fiscal year as is accorded to corporations under this title. If a fiscal year ends during nineteen hundred and sixteen or a subsequent calendar year for which there is a rate of tax different from the rate for the preceding calendar year, then* (1) *the rate for such preceding calendar year shall apply to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and* (2) *the rate for the calendar year during which such fiscal year ends shall apply to the remainder.*

(*f*) In every return shall be included the income derived from dividends on the capital stock or from the net earnings of any corporation, joint-stock company or association, or insurance company, except that in the case of non-resident aliens such income derived from sources without the United States shall not be included.

(*g*) An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis

does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned.

ASSESSMENT AND ADMINISTRATION

Sec. 9. (*a*) That all assessments shall be made by the Commissioner of Internal Revenue and all persons shall be notified of the amount for which they are respectively liable on or before the first day of June of each successive year, and said amounts shall be paid on or before the fifteenth day of June, except in cases of refusal or neglect to make such return and in cases of erroneous, false, or fraudulent returns, in which cases the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, or has been made, make a return upon information obtained as provided for in this title or by existing law, or require the necessary corrections to be made, and the assessment made by the Commissioner of Internal Revenue thereon shall be paid by such person or persons immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the fifteenth day of June in any year, and for ten days after notice and demand thereof by the collector, there shall be added the sum of five per centum on the amount of tax unpaid, and interest at the rate of one per centum per month upon said tax from the time the same became due, except from the estates of insane, deceased, or insolvent persons.

(*b*) All persons, corporations, *partnerships*, associations, and insurance companies, in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees acting in any trust capacity, executors, administrators, receivers, conservators, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual or periodical gains, profits, and income of *any non-resident alien individual*, other than income derived from dividends on capital stock, or from the net earnings of *a corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title*, are hereby

authorized and required to deduct and withhold from such annual or periodical gains, profits, and income, such sum as will be sufficient to pay the normal tax imposed thereon by this title, and *shall make return thereof on or before March first of each year and, on or before the time fixed by law for the payment of the tax,* shall pay the amount withheld to the officer of the United States Government authorized to receive the same; and they are each hereby made personally liable for such tax, and they are each hereby indemnified against every person, corporation, *partnership,* association, *or insurance company,* or demand whatsoever for all payments which they shall make in pursuance and by virtue of this title.

(*c*) *The amount of the normal tax hereinbefore imposed shall also be deducted and withheld from fixed or determinable annual or periodical gains, profits, and income derived from interest upon bonds and mortgages, or deeds of trust or other similar obligations of corporations, joint-stock companies, associations, and insurance companies, (if such bonds, mortgages, or other obligations contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee or to reimburse the obligee for any portion of the tax or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States), whether payable annually or at shorter or longer periods, and whether such interest is payable to a nonresident alien individual or to an individual citizen or resident of the United States, subject to the provisions of the foregoing subdivision (b) of this section requiring the tax to be withheld at the source and deducted from annual income and returned and paid to the Government, unless the person entitled to receive such interest shall file with the withholding agent on or before February first, a signed notice in writing claiming the benefit of an exemption under section seven of this title.*

[Subdivisions (*d*) and (*e*) relating to withholding at the source were repealed.]

(*f*) All persons, corporations, *partnerships, or associations,* undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner of Internal Revenue, and shall be subject to such regulations enabling the Government to *obtain the information re-*

quired under this title, as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe; and *whoever* knowingly undertakes to collect such payments as aforesaid without having obtained a license therefor, or without complying with such regulations, shall be deemed guilty of a misdemeanor and for each offense be fined in a sum not exceeding $5,000, or imprisoned for a term not exceeding one year, or both, in the discretion of the court.

(*g*) The tax herein imposed upon gains, profits, and incomes not falling under the foregoing and not returned and paid by virtue of the foregoing *or as otherwise provided by law* shall be assessed by personal return under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. The intent and purpose of this title is that all gains, profits, and income of a taxable class, as defined by this title, shall be charged and assessed with the corresponding tax, normal and additional, prescribed by this title, and said tax shall be paid by the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same. For the purpose of this title ownership or liability shall be determined as of the year for which a return is required to be rendered.

The provisions of this *section except subdivision* (*c*), relating to the deduction and payment of the tax at the source of income shall only apply to the normal tax hereinbefore imposed upon *non-resident alien* individuals.

PART II.—ON CORPORATIONS

Sec. 10. (*a*) That there shall be levied, assessed, collected and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized but not including partnerships, a tax of two per centum upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources within the United States by every corporation, joint-stock company or association, or insurance company, organized, authorized, or existing under the laws of any foreign country, including interest on bonds, notes, or other interest-bearing obli-

gations of residents, corporate or otherwise, and including the income derived from dividends on capital stock or from net earnings of resident corporations, joint-stock companies or associations, or insurance companies, whose net income is taxable under this title.

The foregoing tax rate shall apply to the total net income received by every taxable corporation, joint-stock company or association, or insurance company in the calendar year nineteen hundred and sixteen and in each year thereafter, except that if it has fixed its own fiscal year under the provisions of existing law, the foregoing rate shall apply to the proportion of the total net income returned for the fiscal year ending prior to December thirty-first, nineteen hundred and sixteen, which the period between January first, nineteen hundred and sixteen, and the end of such fiscal year bears to the whole of such fiscal year, and the rate fixed in Section II of the Act approved October third, nineteen hundred and thirteen, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," shall apply to the remaining portion of the total net income returned for such fiscal year.

For the purpose of ascertaining the gain derived or loss sustained, from the sale or other disposition by a corporation, joint-stock company, or association, or insurance company, of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived or loss sustained.

(b) In addition to the income tax imposed by subdivision (a) of this section there shall be levied, assessed, collected, and paid annually an additional tax of ten per centum upon the amount, remaining undistributed six months after the end of each calendar or fiscal year, of the total net income of every corporation, joint-stock company or association, or insurance company, received during the year, as determined for the purposes of the tax imposed by such subdivision (a), but not including the amount of any income taxes paid by it within the year imposed by the authority of the United States. The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business or is retained for employment in the reasonable requirements of the business

or is invested in obligations of the United States issued after September first, nineteen hundred and seventeen: Provided, That if the Secretary of the Treasury ascertains and finds that any portion of such amount so retained at any time for employment in the business is not so employed or is not reasonably required in the business a tax of fifteen per centum shall be levied, assessed, collected, and paid thereon. The foregoing tax rates shall apply to the undistributed net income received by every taxable corporation, joint-stock company or association, or insurance company in the calendar year nineteen hundred and seventeen and in each year thereafter, except that if it has fixed its own fiscal year under the provisions of existing law, the foregoing rates shall apply to the proportion of the taxable undistributed net income returned for the fiscal year ending prior to December thirty-first, nineteen hundred and seventeen, which the period between January first, nineteen hundred and seventeen, and the end of such fiscal year bears to the whole of such fiscal year.

CONDITIONAL AND OTHER EXEMPTIONS

Sec. 11. (*a*) That there shall not be taxed under this title any income received by any—

First. Labor, agricultural, or horticultural organization;

Second. Mutual savings bank not having a capital stock represented by shares;

Third. Fraternal beneficiary society, order, or association, operated under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

Fourth. Domestic building and loan association and co-operative banks without capital stock organized and operated for mutual purposes and without profit;

Fifth. Cemetery company owned and operated exclusively for the benefit of its members;

Sixth. Corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual;

Seventh. Business league, chamber of commerce, or board of

trade, not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual;

Eighth. Civic league or organization not organized for profit but operated exclusively for the promotion of social welfare;

Ninth. Club organized and operated exclusively for pleasure, recreation, and other non-profitable purposes, no part of the net income of which inures to the benefit of any private stockholder or member;

Tenth. Farmers' or other mutual hail, cyclone, or fire insurance company, mutual ditch or irrigation company, mutual or co-operative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses;

Eleventh. Farmers', fruit growers', or like association, organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of quantity of produce furnished by them;

Twelfth. Corporation or association organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title; or

Thirteenth. Federal land banks and national farm-loan associations as provided in section twenty-six of the Act approved July seventeenth, nineteen hundred and sixteen, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes."

Fourteenth. Joint-stock land banks as to income derived from bonds or debentures of other joint-stock land banks or any Federal land bank belonging to such joint-stock land bank.

(*b*) There shall not be taxed under this title any income derived from any public utility or from the exercise of any essential governmental function accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, nor any income accruing to the government of the

Philippine Islands or Porto Rico, or of any political subdivision of the Philippine Islands or Porto Rico: Provided, That whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, has, prior to the passage of this title, entered in good faith into a contract with any person or corporation, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, or the District of Columbia, or a political subdivision of a State or Territory; but this provision is not intended to confer upon such person or corporation any financial gain or exemption or to relieve such person or corporation from the payment of a tax as provided for in this title upon the part or portion of the said income to which such person or corporation shall be entitled under such contract.

DEDUCTIONS

Sec. 12. (*a*) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use of employment in the business or trade; (*a*) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production, to be ascertained not by the flush flow but by the settled production or regular flow; (*b*) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which

the return and computation are made, such reasonable allowance to be made in the case of both (*a*) and (*b*) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowance authorized in (*a*) and (*b*) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made; and (*c*) in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: Provided, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: Provided further, That mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of their premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: Provided further, That mutual marine insurance companies shall include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof, and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year.

Third. The amount of interest paid within the year on its indebtedness (*except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title*) to an amount of such

indebtedness not in excess of the sum of (*a*) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (*b*) one-half of its interest-bearing indebtedness then outstanding: Provided, That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income: Provided further, That in cases wherein shares of capital stock are issued without par or nominal value, the amount of paid-up capital stock, within the meaning of this section, as represented by such shares, will be the amount of cash, or its equivalent, paid or transferred to the corporation as a consideration for such shares: Provided further, That in the case of indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company or association as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral: Provided further, That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed, or any other tax paid pursuant to such guaranty, shall be allowed; and in the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, shall be deducted;

Fourth. Taxes paid within the year imposed by the authority of the United States (*except income and excess profits taxes*), or *of* its Territories, or possessions, or any foreign country, or *by* the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits.

(*b*) In the case of a corporation, joint-stock company or association, or insurance company, organized, authorized, or existing

under the laws of any foreign country, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources with the United States—

First. All the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

Second. All losses actually sustained within the year in business or trade conducted by it within the United States and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (*a*) and in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (*b*) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (*a*) and (*b*) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowance authorized in (*a*) and (*b*) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made; and (*c*) in the case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: Provided, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made; Provided further, That mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of

the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: Provided further, That mutual marine insurance companies shall include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof, and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year;

Third. The amount of interest paid within the year on its indebtedness (*except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title*) to an amount of such indebtedness not in excess of the proportion of the sum of (*a*) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of the capital employed in the business at the close of the year, and (*b*) one-half of its interest-bearing indebtedness then outstanding, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States: Provided, That in the case of bonds or other indebtedness which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed or any other tax paid pursuant to such guaranty shall be allowed; and in case of a bank, banking association, loan or trust company, or branch thereof, interest paid within the year on deposits by or on moneys received for investment from either citizens or residents of the United States and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, or branch thereof;

Fourth. Taxes paid within the year imposed by the authority of the United States (*except income and excess profits taxes*), or *of* its Territories or possessions, or *by* the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, paid within the United States, not including those assessed aganst local benefits.

(*c*) In the case of assessment insurance companies, whether domestic or foreign, the actual deposit of sums with State or Territorial officers, pursuant to law, as additions to guarantee or reserve funds shall be treated as being payments required by law to reserve funds.

RETURNS.

Sec. 13. (*a*) The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December thirty-first: Provided, That any corporation, joint-stock company or association, or insurance company, subject to this tax, may designate the last day of any month in the year as the day of the closing of its fiscal year and shall be entitled to have the tax payable by it computed upon the basis of the net income ascertained as herein provided for the year ending on the day so designated in the year preceding the date of assessment instead of upon the basis of the net income for the calendar year preceding the date of assessment; and it shall give notice of the day it has thus designated as the closing of its fiscal year to the collector of the district in which its principal business office is located at any time not less than thirty days prior to the first day of March of the year in which its return would be filed if made upon the basis of the calendar year;

(*b*) Every corporation, joint-stock company or association, or insurance company, subject to the tax herein imposed, shall, on or before the first day of March nineteen hundred and seventeen, and the first day of March in each year thereafter, or, if it has designated a fiscal year for the computation of its tax, then within sixty days after the close of such fiscal year ending prior to December thirty-first, nineteen hundred and sixteen, and the close of each such fiscal year thereafter, render a true and accurate return of its annual net income in the manner and form to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, and containing such

facts, data, and information as are appropriate and in the opinion of the commissioner necessary to determine the correctness of the net income returned and to carry out the provisions of this title. The return shall be sworn to by the president, vice president, or other principal officer, and by the treasurer or assistant treasurer. The return shall be made to the collector of the district in which is located the principal office of the corporation, company, or association, where are kept its books of account and other data from which the return is prepared, or in the case of a foreign corporation, company, or association, to the collector of the district in which is located its principal place of business in the United States, or if it have no principal place of business, office, or agency in the United States, then to the collector of internal revenue at Baltimore, Maryland. All such returns shall as received be transmitted forthwith by the collector to the Commissioner of Internal Revenue;

(*c*) In cases wherein receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, joint-stock companies or associations, or insurance companies, subject to tax imposed by this title, such receivers, trustees, or assignees shall make returns of net income as and for such corporations, joint-stock companies or associations, and insurance companies, in the same manner and form as such organizations are hereinbefore required to make returns, and any income tax due on the basis of such returns made by receivers, trustees, or assignees shall be assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control;

(*d*) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned;

(*e*) All the provisions of this title relating to the tax authorized and required to be deducted and withheld and paid to the officer of the United States Government authorized to receive the same from the income of non-resident alien individuals from sources within the United States shall be made applicable to *the*

tax imposed by subdivision (a) of section ten upon incomes derived from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations, joint-stock companies or associations, and insurance companies by non-resident alien firms, copartnerships, companies, corporations, joint-stock companies or associations, and insurance companies, not engaged in business or trade within the United States and not having any office or place of business therein;

(*f*) Likewise, all the provisions of this title relating to the tax authorized and required to be deducted and withheld and paid to the officer of the United States Government authorized to receive the same from the income of non-resident alien individuals from sources within the United States shall be made applicable to income derived from dividends upon the capital stock or from the net earnings of domestic or other resident corporations, joint-stock companies or associations, and insurance companies by non-resident alien companies, corporations, joint-stock companies or associations, and insurance companies not engaged in business or trade within the United States and not having any office or place of business therein.

ASSESSMENT AND ADMINISTRATION

Sec. 14. (*a*) All assessments shall be made and the several corporations, joint-stock companies or associations, and insurance companies shall be notified of the amount for which they are respectively liable on or before the first day of June of each successive year, and said assessment shall be paid on or before the fifteenth day of June: Provided, That every corporation, joint-stock company or association, and insurance company, computing taxes upon the income of the fiscal year which it may designate in the manner hereinbefore provided, shall pay the taxes due under its assessment within one hundred and five days after the date upon which it is required to file its list or return of income for assessment; except in cases of refusal or neglect to make such return, and in cases of erroneous, false, or fraudulent returns, in which cases the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, make a return upon information obtained as provided for in this title or by existing law; and the assessment made by the Commissioner of Internal Revenue thereon shall be

paid by such corporation, joint-stock company or association, or insurance company immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the fifteenth day of June in any year, or after one hundred and five days from the date on which the return of income is required to be made by the taxpayer, and after ten days' notice and demand thereof by the collector, there shall be added the sum of five per centum on the amount of tax unpaid and interest at the rate of one per centum per month upon said tax from the time the same becomes due: Provided, That upon the examination of any return of income made pursuant to this title, the act of August fifth, nineteen hundred and nine, entitled "An act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes", and the act of October third, nineteen hundred and thirteen, entitled "An act to reduce tariff duties and to provide revenue for the Government, and for other purposes", if it shall appear that amounts of tax have been paid in excess of those properly due, the taxpayer shall be permitted to present a claim for refund thereof nothwithstanding the provisions of section thirty-two hundred and twenty-eight of the Revised Statutes;

(*b*) When the assessment shall be made, as provided in this title, the returns, together with any corrections thereof which may have been made by the commissioner, shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such: Provided, That any and all such returns shall be open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President: Provided further, That the proper officers of any State imposing a general income tax may, upon the request of the governor thereof, have access to said returns or to an abstract thereof, showing the name and income of each such corporation, joint-stock company or association, or insurance company, at such times and in such manner as the Secretary of the Treasury may prescribe;

(*c*) If any of the corporations, joint-stock companies or associations, or insurance companies aforesaid shall refuse or neglect to make a return at the time or times hereinbefore specified in each year, or shall render a false or fraudulent return, such corporation, joint-stock company or association, or insurance company

shall be liable to a penalty of not exceeding $10,000: Provided, That the Commissioner of Internal Revenue shall have authority, in the case of either corporations or individuals, to grant a reasonable extension of time in meritorious cases, as he may deem proper;

(*d*) That section thirty-two hundred and twenty-five of the Revised Statutes of the United States be, and the same is hereby, amended so as to read as follows:

"Sec. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, no tax collected under such assessment shall be recovered by any suit unless it is proved that the said list, statement, or return was not false nor fraudulent and did not contain any understatement or undervaluation; but this section shall not apply to statements or returns made or to be made in good faith under the laws of the United States regarding annual depreciation of oil or gas wells and mines."

PART III.—GENERAL ADMINISTRATIVE PROVISIONS

Sec. 15. That the word "State" or "United States" when used in this title shall be construed to include any Territory, the District of Columbia, Porto Rico, and the Philippine Islands, when such construction is necessary to carry out its provisions.

Sec. 16. That sections thirty-one hundred and sixty-seven, thirty-one hundred and seventy-two, thirty-one hundred and seventy-three, and thirty-one hundred and seventy-six of the Revised Statutes of the United States as amended are hereby amended so as to read as follows:

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish

in any manner whatever not provided by law any income return or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"Sec. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"Sec. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, (2) in case of income tax on or before the first day of March in each year, or on or before the last day of the sixty-day period next following the closing date of the fiscal year for which inquire after and concerning all persons therein who are liable to it makes a return of its income, and (3) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the amount of annual income charged with a duty or tax, the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: Provided, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, articles or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented

to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: Provided further, That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest postoffice, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person, or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: Provided, That 'person,' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. Any return or list so made and subscribed by a collector or deputy collector shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall assess all taxes, other than stamp taxes, as to which returns or lists are so made by a collector or deputy collector. In case of any failure to make and file a return or list within the time prescribed by law or by the collector, the Commissioner of Internal Revenue shall add to the tax fifty per centum of its amount except that, when a return is voluntarily and without notice from the collector filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax one hundred per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Sec. 17. That it shall be the duty of every collector of internal revenue, to whom any payment of any taxes is made under the provisions of this title, to give to the person making such payment a full written or printed receipt, expressing the amount paid and the particular account for which such payment was made; and whenever such payment is made such collector shall, if required, give a separate receipt for each tax paid by any debtor, on account of payments made to or to be made by him to separate creditors in such form that such debtor can conveniently produce the same separately to his several creditors in satisfaction of their respective demands to the amounts specified in such receipts; and such receipts shall be sufficient evidence in favor of such debtor to

justify him in withholding the amount therein expressed from his next payment to his creditor; but such creditor may, upon giving to his debtor a full written receipt, acknowledging the payment to him of whatever sum may be actually paid, and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipts.

Sec. 18. That any *person, corporation, partnership, association, or insurance company,* liable *to pay the tax,* to make *a* return or *to supply information required under this title,* who refuses or neglects *to pay such tax,* to make such return *or to supply such information* at the time or times herein specified in each year, shall be liable, *except as otherwise specially provided in this title,* to a penalty of not less than $20 nor more than $1,000. Any individual or any officer of any corporation, *partnership,* association, or insurance company, required by law to make, render, sign, or verify any return *or to supply any information,* who makes any false or fraudulent return or statement with intent to defeat or evade the assessment required by this title to be made, shall be guilty of a misdemeanor, and shall be fined not exceeding $2,000 or be imprisoned not exceeding one year, or both, in the discretion of the court, with the costs of prosecution: Provided, That where any tax heretofore due and payable has been duly paid by the taxpayer, it shall not be re-collected from any *withholding agent* required to retain it at its source, nor shall any penalty be imposed or collected in such cases from the taxpayer, or such *withholding agent* whose duty it was to retain it, for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

Sec. 19. The collector or deputy collector shall require every return to be verified by the oath of the party rendering it. If the collector or deputy collector have reason to believe that the amount of any income returned is understated, he shall give due notice to the person making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated may increase the same accordingly. Such person may furnish sworn testimony to prove any relevant facts, and, if dissatisfied with the decision of the collector, may appeal to the Commissioner of Internal Revenue for his decision under such rules of procedure as may be prescribed by regulation.

Sec. 20. That jurisdiction is hereby conferred upon the district

courts of the United States for the district within which any person summoned under this title to appear to testify or to produce books shall reside, to compel such attendance, production of books, and testimony by appropriate process.

Sec. 21. That the preparation and publication of statistics reasonably available with respect to the operation of the income tax law and containing classifications of taxpayers and of income, the amounts allowed as deductions and exemptions, and any other facts deemed pertinent and valuable, shall be made annually by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury.

Sec. 22. That all administrative, special, and general provisions of law, including the laws in relation to the assessment, remission, collection, and refund of internal-revenue taxes not heretofore specifically repealed and not inconsistent with the provisions of this title, are hereby extended and made applicable to all the provisions of this title and to the tax herein imposed.

Sec. 23. That the provisions of this title shall extend to Porto Rico and the Philippine Islands: Provided, That the administration of the law and the collection of the taxes imposed in Porto Rico and the Philippine Islands shall be by the appropriate internal-revenue officers of those governments, and all revenues collected in Porto Rico and the Philippine Islands thereunder shall accrue intact to the general governments thereof, respectively: Provided further, That the jurisdiction in this title conferred upon the district courts of the United States shall, so far as the Philippine Islands are concerned, be vested in the courts of the first instance of said islands: And provided further, That nothing in this title shall be held to exclude from the computation of the net income the compensation paid any official by the governments of the District of Columbia, Porto Rico, and the Philippine Islands, or the political subdivisions thereof.

Sec. 24. That Section II of the Act approved October third, nineteen hundred and thirteen, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," is hereby repealed, except as herein otherwise provided, and except that it shall remain in force for the assessment and collection of all taxes which have accrued thereunder, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any of such taxes, and except that the unexpended balance of any appropriation heretofore made

and now available for the administration of such section or any provision thereof shall be available for the administration of this title or the corresponding provision thereof.

Sec. 25. That income on which has been assessed the tax imposed by Section II of the Act entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," approved October third, nineteen hundred and thirteen, shall not be considered as income within the meaning of this title: Provided, That this section shall not conflict with that portion of section ten, of this title, under which a taxpayer has fixed its own fiscal year.

Sec. 26. Every corporation, joint-stock company or association, or insurance company subject to the tax herein imposed, when required by the Commissioner of Internal Revenue, shall render a correct return, duly verified under oath, of its payments of dividends, whether made in cash or its equivalent or in stock, including the names and addresses of stockholders and the number of shares owned by each, *and the tax years and the applicable amounts in which such dividends were earned,* in such form and manner as may be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.

Sec. 27. That every person, corporation, partnership, or association, doing business as a broker on any exchange or board of trade or other similar place of business shall, when required by the Commissioner of Internal Revenue, render a correct return duly verified under oath, under such rules and regulations as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, may prescribe, showing the names of customers for whom such person, corporation, partnership, or association has transacted any business, with such details as to the profits, losses, or other information which the commissioner may require, as to each of such customers, as will enable the Commissioner of Internal Revenue to determine whether all income tax due on profits or gains of such customers has been paid.

Sec. 28. That all persons, corporations, partnerships, associations, and insurance companies, in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees acting in any trust capacity, executors, administrators, receivers, conservators, and employers, making payment to another person, corporation, partnership, association, or insurance company, of interest, rent, salaries, wages, premiums, annuities, compensation,

remuneration, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections twenty-six and twenty-seven), of $800 *or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, are hereby authorized and required to render a true and accurate return to the Commissioner of Internal Revenue, under such rules and regulations and in such form and manner as may be prescribed by him, with the approval of the Secretary of the Treasury, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment: Provided, That such returns shall be required, regardless of amounts, in the case of payments of interest upon bonds and mortgages or deeds of trust or other similar obligations of corporations, joint-stock companies, associations, and insurance companies, and in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest from the bonds and dividends from the stock of foreign corporations by persons, corporations, partnerships, or associations, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange. When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the person, corporation, partnership, association, or insurance company paying the income.*

The provisions of this section shall apply to the calendar year nineteen hundred and seventeen and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

Sec. 29. *That in assessing income tax the net income embraced in the return shall also be credited with the amount of any excess profits tax imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer, and, in the case of a member of a partnership, with his proportionate share of such excess profits tax imposed upon the partnership.*

Sec. 30. *That nothing in section II of the Act approved October third, nineteen hundred and thirteen, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," or in this title, shall be construed as*

taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments.

Sec. 31. (*a*) *That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earnings or profits so distributed.*

(*b*) *Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.*

Sec. 32. *That premiums paid on life insurance policies covering the lives of officers, employees, or those financially interested in any trade or business conducted by an individual, partnership, corporation, joint-stock company or association, or insurance company, shall not be deducted in computing the net income of such individual, corporation, joint-stock company or association, or insurance company, or in computing the profits of such partnership for the purposes of subdivision* (*e*) *of section nine.*

Sec. 1212. *That any amount heretofore withheld by any with-*

holding agent as required by Title I of such Act of September eighth, nineteen hundred and sixteen, on account of the tax imposed upon the income of any individual, a citizen or resident of the United States, for the calendar year nineteen hundred and seventeen, except in the cases covered by subdivision (c) of section nine of such Act, as amended by this Act, shall be released and paid over to such individual, and the entire tax upon the income of such individual for such year shall be assessed and collected in the manner prescribed by such Act as amended by this Act.

TEXT OF 1917 LAW

ACT OF OCTOBER 3, 1917

TITLE I.—WAR INCOME TAX

Section 1. That in addition to the normal tax imposed by subdivision (*a*) of section one of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per centum upon the income of every individual, a citizen or resident of the United States, received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

Sec. 2. That in addition to the additional tax imposed by subdivision (*b*) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the income of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:

One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500;

Two per centum per annum upon the amount by which the total net income exceeds $7,500 and does not exceed $10,000;

Three per centum per annum upon the amount by which the total net income exceeds $10,000 and does not exceed $12,500;

Four per centum per annum upon the amount by which the total net income exceeds $12,500 and does not exceed $15,000;

Five per centum per annum upon the amount by which the total net income exceeds $15,000 and does not exceed $20,000;

Seven per centum per annum upon the amount by which the total net income exceeds $20,000 and does not exceed $40,000;

Ten per centum per annum upon the amount by which the total net income exceeds $40,000 and does not exceed $60,000;

Fourteen per centum per annum upon the amount by which the total net income exceeds $60,000 and does not exceed $80,000;

Eighteen per centum per annum upon the amount by which the total net income exceeds $80,000 and does not exceed $100,000;

Twenty-two per centum per annum upon the amount by which the total net income exceeds $100,000 and does not exceed $150,000;

Twenty-five per centum per annum upon the amount by which the total net income exceeds $150,000 and does not exceed $200,000;

Thirty per centum per annum upon the amount by which the total net income exceeds $200,000 and does not exceed $250,000;

Thirty-four per centum per annum upon the amount by which the total net income exceeds $250,000 and does not exceed $300,000;

Thirty-seven per centum per annum upon the amount by which the total net income exceeds $300,000 and does not exceed $500,000;

Forty per centum per annum upon the amount by which the total net income exceeds $500,000 and does not exceed $750,000;

Forty-five per centum per annum upon the amount by which the total net income exceeds $750,000 and does not exceed $1,000,000;

Fifty per centum per annum upon the amount by which the total net income exceeds $1,000,000.

Sec. 3. That the taxes imposed by sections one and two of this Act shall be computed, levied, assessed, collected, and paid upon the same basis and in the same manner as the similar taxes imposed by section one of such Act of September eighth, nineteen hundred and sixteen, except that in the case of the tax imposed by section one of this Act (*a*) the exemptions of $3,000 and $4,000 provided in section seven of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, shall be, respectively, $1,000 and $2,000, and (*b*) the returns required under subdivisions (*b*) and (*c*) of section eight of such Act, as amended by this Act, shall be required in the case of net incomes of $1,000 or over, in the case of unmarried persons, and $2,000 or over in the case of married persons, instead of $3,000 or over, as therein provided, and (*c*) the provisions of subdivision (*c*) of section nine of such Act, as amended by this Act, requiring the normal tax of individuals on income derived from interest to be deducted and withheld at the source of the income shall not apply to the new

two per centum normal tax prescribed in section one of this Act until on and after January first, nineteen hundred and eighteen, and thereafter only one two per centum normal tax shall be deducted and withheld at the source under the provisions of such subdivision (*c*), and any further normal tax for which the recipient of such income is liable under this Act or such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, shall be paid by such recipient.

Sec. 4. That in addition to the tax imposed by subdivision (*a*) of section ten of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, by every corporation, joint-stock company or association, or insurance company, subject to the tax imposed by that subdivision of that section, except that if it has fixed its own fiscal year, the tax imposed by this section for the fiscal year ending during the calendar year nineteen hundred and seventeen shall be levied, assessed, collected, and paid only on that proportion of its income for such fiscal year which the period between January first, nineteen hundred and seventeen, and the end of such fiscal year bears to the whole of such fiscal year.

The tax imposed by this section shall be computed, levied, assessed, collected, and paid upon the same incomes and in the same manner as the tax imposed by subdivision (*a*) of section ten of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, except that for the purpose of the tax imposed by this section the income embraced in a return of a corporation, joint-stock company or association, or insurance company, shall be credited with the amount received as dividends upon the stock or from the net earnings of any other corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title.

Sec. 5. That the provisions of this title shall not extend to Porto Rico or the Philippine Islands, and the Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

ADMINISTRATIVE PROVISIONS OF THE ACT OF OCTOBER 3, 1917[1]

Sec. 1009. That the Secretary of the Treasury, under rules and regulations prescribed by him, shall permit taxpayers liable to income and excess profits taxes to make payments in advance in installments or in whole of an amount not in excess of the estimated taxes which will be due from them, and upon determination of the taxes actually due any amount paid in excess shall be refunded as taxes erroneously collected: *Provided,* That when payment is made in installments at least one-fourth of such estimated tax shall be paid before the expiration of thirty days after the close of the taxable year, at least an additional one-fourth within two months after the close of the taxable year, at least an additional one-fourth within four months after the close of the taxable year, and the remainder of the tax due on or before the time now fixed by law for such payment: *Provided further,* That the Secretary of the Treasury, under rules and regulations prescribed by him, may allow credit against such taxes so paid in advance of an amount not exceeding three per centum per annum calculated upon the amount so paid from the date of such payment to the date now fixed by law for such payment; but no such credit shall be allowed on payments in excess of taxes determined to be due, nor on payments made after the expiration of four and one-half months after the close of the taxable year.

All penalties provided by existing law for failure to pay tax when due are hereby made applicable to any failure to pay the tax at the time or times required in this section.

Sec. 1010. That under rules and regulations prescribed by the Secretary of the Treasury, Collectors of Internal Revenue may receive, at par and accrued interest, certificates of indebtedness issued under section six of the Act entitled "An Act to authorize an issue of bonds to meet expenditures for the national security and defense, and, for the purpose of assisting in the prosecution of the war, to extend credit to foreign governments, and for other purposes," approved April twenty-fourth, nineteen hundred and seventeen, and any subsequent Act or Acts, and uncertified checks in payment of income and excess profits taxes, during such time

[1] These provisions apply to the 1916 Law and the 1917 Law. They are contained in Title X of the Act of October 3, 1917.

and under such regulations as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

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[1] 1909 Law.
[2] 1913 Law.

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